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TAXATION OF BANKS AND THRIFT INSTITUTIONS

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INTRODUCTION

This study has been prepared by the staff of the Joint Committee on Taxation at the request of Chairman Robert Dole in connection with the Senate Committee on Finance's hearing on the taxation of banks, savings and loan associations and credit unions, scheduled for March 11, 1983.

The first part of the study is an overview. The second part presents data on the amount of income tax paid by banks and savings and loan associations in recent years and the effective tax rate of banks in 1981, along with a discussion of the significance of the effective tax rate concept and some of the issues involved in measuring effective tax rates. The third part analyzes a number of areas in the income tax law where the rules for financial institutions differ from those applied to other taxpayers or where general rules are of particular significance for banks, including discussions of present law, the legislative history and the analytical issues involved.

I. OVERVIEW

This study is an initial effort to address the federal income tax treatment of commercial banks, mutual savings banks, savings and loan associations and credit unions. In recent years, these financial institutions have in most cases either paid no U.S. federal income tax or have paid rates of U.S. federal income tax that are a relatively low percentage of income. For some institutions, a low or zero U.S. tax burden resulted from the fact that few or no profits were earned; however, the relatively low tax burdens of financial institutions also result from a variety of provisions in the tax law that treat financial institutions differently from other taxpayers.

Taxes paid by financial institutions and effective tax rates

In 1978, a relatively profitable year for financial institutions, commercial banks and thrift institutions (mutual savings banks and savings and loan associations) paid about $3 billion of U.S. federal income tax (out of total tax liability for U.S. corporations of $64 billion). $1.6 billion was paid by commercial banks, $1.3 billion by savings and loan associations and $0.2 billion by mutual savings banks. By 1980, the tax liability of commercial banks had fallen to $1.4 billion. 1980 was an unprofitable year for many thrift institutions, however, and the tax liabilities of savings and loan associations fell to $188 million and that of mutual savings banks to $23 million.

It is possible to use published data from annual reports to estimate effective tax rates paid by individual commercial banks in 1981, although such estimates are based on controversial methodological assumptions and can vary widely. In 1981, large banks appear to have paid relatively little U.S. tax, although the tax rate appears to be significantly higher when foreign taxes are counted. To some extent, the low U.S. tax rate results from tax provisions that create a deferral of tax liability that can be expected to lead to tax liability in some future year.

The principal provisions of the law that reduced the tax of banks in 1981 include the exclusion for interest on State and local government bonds and tax benefits associated with leasing activities. To the extent that these investments by banks earned a lower pre-tax rate of return than comparable but fully taxable investments, it may be argued that the banks did bear an indirect economic burden attributable to the income tax apart from the actual tax payments they made.

Specific tax provisions affecting financial institutions

Bad debt reserves.—Commercial banks and thrift institutions are allowed to deduct additions to bad debt reserves in excess of their actual loan losses and, some argue, in excess of what would be needed to produce a proper economic measure of income. In the case of thrift institutions, the excess bad debt reserves are intended to encourage investment in home mortgages and certain other types of assets, but there has been criticism of the structure of this incentive in the light of recent regulatory changes.

Tax-exempt bonds.—Unlike other taxpayers, banks can deduct interest on obligations allocable to tax-exempt securities. Congress placed limits on this deduction in 1982. This interpretation of present law gives banks a tax benefit not enjoyed by other taxpayers, which may create a competitive advantage for banks over other taxpayers, such as broker-dealers, when they engage in similar businesses. Also, there are cases where these interest deductions can lead to what some consider to be too much assistance being provided, such as when bank deposits of a State or local government are collateralized by that government's tax-exempt obligations. However, limits on the deductibility of interest used to purchase or carry tax-exempt securities may affect the market for tax-exempt bonds to the detriment of the issuing governments and other beneficiaries of tax-exempt financing.

Foreign-source income.—Many large banks earn most of their income outside the United States. As a result of the tax rules for foreign source income that are generally applicable to corporations, but perhaps more beneficial to banks because of the nature of their business, banks pay little or no U.S. tax on their foreign operations. Moreover, the rules may be viewed as making certain foreign loans more attractive than U.S. loans. Furthermore, some of the present rules on foreign-source income may operate to permit banks to reduce their U.S. tax burden on U.S. income.

Credit unions.—Credit unions are tax-exempt, even on income accumulated rather than distributed as dividends to their members. Since this exemption was last considered by Congress, some credit unions have expanded to become large, sophisticated organizations, and it may be appropriate to re-examine the exemption.

Dividend deductions.—Mutual savings and loan associations and mutual savings banks may deduct 100 percent of dividends to their shareholder-depositors. In contrast, mutual life insurance companies may deduct only 77½ percent of policyholder dividends. To the extent that dividends of mutual financial institutions are viewed as a return on the equity of the institutions, some limit on deductibility may be appropriate to achieve a proper measurement of income.

Other provisions.—Several other provisions of the tax law provide special treatment for financial institutions, including exemption from the restrictions on commodity tax straddles, the ability to deduct costs of starting a credit card business, special rules for loan foreclosures, special merger rules and special rules for loss carryovers and carrybacks.

II. INCOME TAX PAID BY FINANCIAL INSTITUTIONS AND EFFECTIVE TAX RATES

A. Income Tax Paid by Financial Institutions

The U.S. income tax liability of commercial banks, mutual savings banks and savings and loan associations for the years 1976 to 1980 is shown in Table 1. Total U.S. income tax liability of these taxpayers increased from $1,659 million in 1976 to $3,089 million in 1978, but fell in 1980 to $1,597 million, essentially the pre-1976 level. Income liability of commercial banks increased from $896 million in 1976 to $1,833 million in 1979 and then decreased to $1,386 million in 1980. Tax liability of mutual savings banks rose from $111 million in 1976 to $184 million in 1978 and then declined to $23 million in 1980. Tax liability of savings and loan associations decreased from a high of $1,260 million in 1978 to $188 million in 1980. The sharp decline in tax liability of savings banks and savings and loan associations in 1980 reflected the extremely low profitability of many of those institutions in that year. The data in table 1 do not take into account the effects of net operating loss or credit carrybacks from subsequent years that reduced (or will reduce) tax liability for the years shown in the table. To this extent, they overstate the taxes that will ultimately be paid for these years.

Credit unions paid no income tax because of their statutory exemption.

Table 1.—Income Tax Liability of Financial Institutions, 1976–1980

[In millions of dollars]

Year	Savings and loan associations	Mutual savings banks	Commercial banks	Total
1976	652	111	896	1,659
1977	968	146	1,112	2,226
1978	1,260	184	1,645	3,089
1979	932	124	1,833	2,889
1980	188	23	1,386	1,597

Source: Internal Revenue Service, "Statistics of Income: Corporation Income Tax Returns," various years.

B. Effective Tax Rates of Large Commercial Banks

This section presents an analysis of the effective tax rates paid by 20 large commercial banks in 1981.[1] It includes a discussion of the methodology used to compute effective tax rates from data derived primarily from corporate annual reports. It also includes a discussion of the principal reasons why effective tax rates differed from the 46-percent statutory corporate income tax rate.

Background

One definition of a corporation's "effective tax rate" is simply the income tax it owes in a particular year divided by its income for that year. The Securities and Exchange Commission requires that corporations include in their annual reports a reconciliation between their actual effective tax rate and the maximum statutory corporate tax rate (now 46 percent).[2] Because data from corporate income tax returns are only available several years after the taxable year for which the returns are filed and returns of individual banks are confidential, the annual reports present the most up-to-date and accessible evidence on corporate effective tax rates. However, a number of problems arise in using these data for this purpose. These are discussed below.

If generally accepted accounting principles[3] and tax accounting rules were exactly the same and there were no tax credits, then all corporations would show an effective rate of tax equal to the statutory rate. The differences between the tax and financial accounting rules, and tax credits, account for the difference between effective tax rates and the statutory rate. Some of these differences are referred to as timing differences, which will reverse in a future period, and others are permanent differences, which will not reverse.

Permanent differences arise from statutory provisions under which specified revenues are exempt from taxation, deductions are allowed for tax purposes for items not counted as expenses for book accounting purposes, and specified expenses (for book purposes) are not allowable as deductions in determining taxable income. An example of a permanent difference is the interest received on municipal bonds, which is included in income for book purposes but excluded for tax purposes. Another example is the 15-percent reduction in the amount allowable as a deduction with respect to any financial institution preference item. Other permanent differences arise from items entering into the determination of taxable income which are not components of pretax accounting income in any period. Examples include the deduction for intercorporate dividends received and the excess of percentage depletion over cost depletion. Another type of permanent difference is a tax credit.

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[1] The staff has made no attempt to analyze effective tax rates for other types of financial institutions. Savings and loan associations and mutual savings banks were, in general, sufficiently unprofitable in 1981 that an effective tax rate calculation would not be meaningful.

[2] APB Opinion No. 11 recommends that significant differences between pretax accounting income and taxable income be disclosed. The Securities and Exchange Commission formalized this rule to require a reconciliation of the effective tax rate to the statutory rate (Rule 17, CFR 210.4–08(h)). In addition, any timing difference that is 5 percent or more of total timing differences is generally disclosed separately.

[3] Generally, the rules for accounting for income taxes are described in APB Opinion No. 11, as amended.

In financial statements, an effective tax rate is computed by comparing the provision for income taxes with net income before tax. This effective tax rate is reconciled to the statutory rate by identifying the permanent differences which give rise to the differences in rates.

Timing differences arise from differences between the periods in which transactions affect taxable income and the periods in which they enter into the determination of pretax accounting income. Each timing difference originates in one period and reverses in one or more subsequent periods. For example, depreciation may be reported on an accelerated basis for tax purposes but on a straight-line basis for accounting purposes. Gross profits on installment sales are recognized for accounting purposes in the period of sale, but are reported for tax purposes in the period the installments are collected.

The accounting recognition of the tax effects of timing differences is based on the concept of interperiod tax allocation. Under this concept, the provision for income taxes on the financial statement for a given year includes all the tax effects of the revenue and expense transactions included in the determination of pretax accounting income for that year. Thus, the total tax expense for the year is the statutory rate times income before tax, plus or minus whatever adjustments are needed to allow for permanent differences. Some portion of this expense is due currently under the tax law while the rest will be due in the future. The portion that is due currently is termed "current tax expense," and the portion that will be due in the future is termed "deferred tax expense." [4]

Effective tax rates computed from financial statements

Effective tax rates can be computed from data published in annual reports using various methodologies regarding the appropriate measurement of "taxes paid" and "income." It is important to note that there has been a good deal of controversy about just what methodology is appropriate for this purpose and that the resulting effective tax rate measures can vary markedly.

Deferred taxes.—The principal methodological issue concerns the treatment of deferred taxes. As noted above, these represent taxes which are not currently paid, which would have been paid had the statutory tax rate been applied to book income, and which are not attributable to permanent differences between tax and book rules.

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[4] Deferred tax expense can be negative, which will be the case whenever book accounting principles require that expenses be deducted prior to the time they are deductible for tax purposes or income reported later than the time it is included for tax purposes. Current tax expense can also be negative, which will be the case when carrybacks result in income tax refunds.

Under the book accounting rules, deferred taxes are treated as a current year's tax expense. However, for many corporations, particularly during a period of growth or inflation, deferred taxes roll over from one year to the next and are, in fact, never paid or will be paid in the distant future. The actual burden of each dollar of deferred tax liability, therefore, is less than that of each dollar of current tax liability and will depend upon the period of deferral and prevailing interest rates. Accounting for deferred tax liability as equivalent to current tax liability may be appropriate as a way of obtaining a conservative measure of after-tax income, but it would not be an appropriate way to measure the income tax burden for the purpose of ascertaining a company's or an industry's contribution to Treasury revenues. Conversely, completely neglecting the deferred tax liability will understate the true tax burden to the extent that the present value of the deferred tax liability is positive. (i.e., to the extent that some tax will be paid in the future).

Under some circumstances, a corporation may recognize the future tax benefits of loss or credit carryforwards in the book provision for current taxes. Thus, loss corporations may show a negative current tax expense not only because they are receiving refunds from loss or credit carrybacks but also because they are anticipating use of carryforwards in the future. In this event, the book provision for current taxes may be understated compared with actual tax liability. However, to qualify for current recognition, the future tax benefit of loss carryforwards must be "assured beyond any reasonable doubt".[5] This stringent requirement prohibits the recognition of future tax benefits of net operating loss carryforwards except in unusual and rare circumstances. The accounting rules for claiming a reduction in current tax expense for investment credit carryovers, however, are more lenient.

Effective tax rates disclosed in the financial statements, in effect, are based on the assumption that the present value of deferred taxes is the same as their stated value. In the 1981 Tax Year Corporate Tax Study, done by the staff at the request of Congressmen Pease and Dorgan (henceforth called the Pease-Dorgan Study), effective tax rates were based on the opposite assumption that the present value of deferred taxes is zero.[6] In the study of Effective Corporate Tax Rates in 1981 by *Tax Notes* (henceforth called the Tax Notes Study) deferred taxes were included in the computation of effective tax rates to the extent that the author assumed that they would be paid in subsequent years.[7] Thus, a range of effective tax rates, each based on different assumptions, is available for purposes of evaluation and comparison.

Foreign and nonfederal taxes.—A second important methodological question concerns just what types of taxes should be counted in the numerator of the effective tax rate fraction. (Other taxes should be subtracted before determining the denominator). Should worldwide taxes be counted or just U.S. taxes? Should taxes at all levels of government be counted or just taxes at the Federal level? Should only taxes on net income be counted or other types of taxes as well (like withholding taxes on gross interest income or excise taxes like the crude oil windfall profit tax)? The data on financial statements often do not distinguish between these different types of taxes in order to make possible alternative computations.

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[5] APB Opinion No. 11 (in paragraphs 45–47).

[6] 128 Cong. Rec. H10545, 153–Part II (daily ed. Dec. 20, 1982) (remarks of Rep. Pease).

[7] "Effective Corporate Tax Rates in 1981, A Special Supplement," prepared by the Editors of *Tax Notes,* 561.

Carryforwards and carrybacks.—A third methodological question concerns the effect of carryforwards from prior years into the current year, and carrybacks from the current year to prior years. A net operating loss carried forward from a prior year will reduce taxable income, and consequently taxes, but not necessarily book income, in the current year. Thus, an effective tax rate computed on book income may be understated. Similarly, even in a year when there is book income, there may be a tax net operating loss which can be carried back to prior years. The refunds attributable to this carryback reduce tax liability for book purposes in the current year. Thus, the effective tax rates will be understated and may, in fact, be negative. Income tax credit carryovers and carrybacks can distort effective tax rates in a similar fashion.

The information needed to eliminate the effect on effective tax rates of carryovers and carrybacks is not always available in the financial statements. Consequently, such adjustments are not made in either the Pease-Dorgan or the *Tax Notes* studies.

Effective tax rates of large corporations by industry

The effective tax rates of selected large corporations for 1981, grouped by industry, is shown in Table 2. These come from the Pease-Dorgan Study. Under the methodology used in this study, effective tax rates are computed by comparing reported current income tax expense with net income before tax.

Where data are available to separate foreign and domestic earnings, a foreign tax rate on foreign income and a U.S. tax rate on U.S. income are computed in addition to the worldwide rate on worldwide income. For several reasons, however, the foreign tax rates shown may not be comparable with the U.S. tax rates. The identification of income as either foreign or U.S.-source on financial statements may not be consistent with the sourcing rules for income tax purposes; foreign tax expense may include amounts which are not creditable foreign taxes for purposes of the foreign tax credit; and foreign currency translation gains and losses are treated as foreign income, which can distort the foreign tax rate.

Some effective tax rates in this study are negative. Generally, as discussed earlier, a negative effective tax rate occurs when there is a book income but a tax loss for the year. The tax loss gives rise to a refund (or claim for refund) of past taxes, which is both measurable and currently realizable; therefore, the tax effect of the loss is recognized in the provision for taxes in the current year. Hence, the refund (negative tax expense) is compared with book income (positive), resulting in a negative tax rate.

Table 2.—Federal Corporate Income Tax Rates of Selected Companies by Industry, 1981

[Dollar amounts in thousands]

Industry	U.S. income before tax	Foreign income [1] before tax	Worldwide income [2] before tax	Current U.S. tax expense	Current foreign tax expense [1]	Current worldwide tax expense	U.S. tax rate on U.S. income	Foreign tax rate on foreign income	World-wide rate on worldwide income
Aerospace	$2,282,317	$473,541	$2,755,858	$155,291	$172,943	$339,834	6.8	36.5	12.3
Beverages.....	1,186,983	885,719	2,072,702	342,251	346,457	688,708	28.8	39.1	33.2
Chemicals	3,116,500	2,707,400	5,823,900	154,300	1,545,800	1,700,100	5.0	57.1	29.2
Commercial banks	2,050,168	3,274,376	5,312,823	47,975	1,247,677	1,311,036	2.3	38.1	24.7
Crude oil production............	996,075	2,470,226	3,887,881	31,043	1,833,019	2,040,988	3.1	74.2	52.5
Diversified financials...........	1,653,911	238,357	2,282,168	277,816	93,645	399,161	16.8	39.3	17.5
Diversified services.....	1,714,074	951,309	2,522,970	507,179	319,152	693,958	29.6	33.5	27.5
Electronics, appliances.........	4,551,281	1,703,692	6,222,036	1,335,269	722,004	2,131,060	29.3	42.4	34.3
Food processors............	2,809,725	905,571	3,715,296	752,603	458,973	1,211,576	26.8	50.7	32.6

Table 2.—Federal Corporate Income Tax Rates of Selected Companies by Industry, 1981—Continued

[Dollar amounts in thousands]

Industry	U.S. income before tax	Foreign income [1] before tax	Worldwide income [2] before tax	Current U.S. tax expense	Current foreign tax expense [1]	Current worldwide tax expense	U.S. tax rate on U.S. income	Foreign tax rate on foreign income	World-wide rate on worldwide income
Industrial and farm equipment..........	1,594,768	438,395	2,033,163	383,574	177,167	560,741	24.1	40.4	27.6
Metal manufacturing........	2,557,389	329,755	3,297,944	249,680	115,820	382,000	9.8	35.1	11.6
Motor vehicles.....	1,188,694	468,088	1,099,982	566,704	456,299	240,103	47.7	97.5	21.8
Office equipment..........	4,327,124	2,877,055	7,204,179	1,093,007	1,725,520	2,818,527	25.3	60.0	39.1
Oil and refining.....	21,489,584	19,737,334	47,638,253	4,003,997	11,913,965	18,092,162	18.6	60.4	38.0
Paper and wood products....	1,354,143	197,959	1,552,102	(192,877)	57,339	(135,538)	(14.2)	29.0	(8.7)
Pharmaceuticals ...	1,692,049	1,280,600	2,972,649	606,782	619,915	1,176,697	35.9	48.4	39.6
Retailing	2,365,877	301,268	2,621,145	536,268	123,822	642,090	22.7	41.1	24.5
Tobacco	2,593,421	536,340	3,129,761	811,881	110,678	922,559	31.3	20.6	29.5

Transportation:									
Airlines....	239,571	95,635	326,374	38,533	25,800	57,469	16.1	27.0	17.6
Railroads..	1,723,273	([3])	1,723,273	(129,434)	([3])	(129,434)	(7.5)	([3])	(7.5)
Trucking..	796,654	10,826	795,395	367,550	5,183	372,733	46.1	47.9	46.9
Utilities........	15,375,821	204,521	16,202,651	1,417,224	83,024	1,514,037	9.2	40.6	9.3

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[1] Foreign income as disclosed in the financial statements may not reflect an allocation between foreign and domestic income that is consistent with U.S. tax rules. Current foreign tax expense may include amounts which are not creditable foreign taxes for purposes of the foreign tax credit under the applicable U.S. tax rules. For this and other reasons (such as foreign currency translation gains and losses), the foreign tax rate may not be comparable with the U.S. tax rate.

[2] Worldwide income is not necessarily the total of U.S. income and foreign income because some companies do not disclose foreign earnings and because losses are excluded from group totals. Thus, the worldwide tax rate does not necessarily fall between the U.S. and foreign tax rates.

[3] Not available.

The twenty large commercial banks included in the Pease-Dorgan Study had an average worldwide effective tax rate of 24.7 percent, a U.S. tax rate of 2.3 percent and a foreign tax rate of 38.1 percent.

The U.S. tax rates on U.S. income varied widely among industries, from a negative 14.2 percent for paper and wood products to 47.7 percent for motor vehicles. However, the rate for banks of 2.3 percent was lower than for any industry except paper and wood products (an industry which was severely depresssed in 1981) and railroads.

Worldwide tax rates also varied over a broad range from negative 8.7 percent for the paper and wood products industry to 52.5 percent for crude oil production. The worldwide tax rate of 24.7 percent for commercial banks was not markedly lower than for many other industries.

Effective tax rates of large commercial banks

The effective tax rates for each bank included in the commercial banks group in the Pease-Dorgan Study are shown in Table 3. Effective tax rates for the 10 largest banks are shown separately. These banks had a higher worldwide effective tax rate (30.3 percent compared with 24.5 percent) and U.S. effective tax rate (9.7 percent compared with 2.7 percent) than the group of 20 banks. (The totals in table 3 differ slightly from the table 2 totals primarily because table 3 totals include all 20 banks, while table 2 totals exclude banks with losses.)

Table 3.—Federal Income Tax Rates for 20 Large Commerical Banks, 1981

[Dollar amounts in thousands]

Bank	Worldwide			United States			Foreign		
	Income	Tax	Rate [1]	Income	Tax	Rate [1]	Income	Tax	Rate [2]
Bank America	$602,950	$169,000	28.0	$153,950	($18,000)	(11.7)	$449,000	$187,000	41.6
CitiCorp	778,917	405,000	52.1	(81,803)	15,000	([3])	860,720	390,000	45.3
Chase Manhattan	509,731	177,048	34.7	109,552	16,272	14.9	400,179	160,776	40.2
Manufacturers Hanover Trust	311,490	91,224	29.3	(38,497)	3,333	([3])	349,987	87,891	25.1
J. P. Morgan & Co	478,300	97,900	20.5	204,900	38,900	19.0	273,400	59,000	21.6
Continental Illinois	361,079	86,377	23.9	234,259	38,813	14.3	126,820	52,956	41.8
Chemical New York	230,916	55,249	23.9	138,462	4,400	3.2	92,454	50,849	55.0
First Interstate	245,910	18,100	7.4	206,910	12,100	5.8	39,000	6,000	15.4
Bankers Trust New York	244,970	61,509	25.1	45,258	(894)	(2.0)	199,712	62,403	31.2
First Chicago	142,509	22,100	15.5	103,209	200	.2	39,300	21,900	55.7
Subtotal	3,906,772	1,183,507	30.3	1,076,200	104,732	9.7	2,830,572	1,078,775	38.1
Security Pacific	311,788	28,176	9.0	264,916	6,184	2.3	46,872	21,992	46.9
Wells Fargo	145,778	17,613	12.1	52,778	2,808	5.3	93,000	14,805	15.9
Crocker National	68,645	8,397	12.2	7,997	(16,449)	(205.7)	60,648	24,846	41.0
Marine Midland	107,103	19,670	18.4	64,423	4,821	7.5	42,680	14,849	34.8
Mellon National	123,101	(22,106)	(18.0)	102,522	(39,757)	(38.8)	20,579	17,651	85.8
Irving Bank	123,368	15,362	12.5	65,461	1,074	1.6	57,907	14,288	24.7
Interfirst	186,000	31,000	16.7	163,000	29,000	17.8	23,000	2,000	8.7
First National Boston	151,981	41,293	27.2	65,591	(15,703)	(23.9)	86,390	56,996	66.0
Northwest Bancorp	98,577	(2,949)	(3.0)	([3])	([3])	([3])	([3])	([3])	([3])
First Bank System	81,874	(22,153)	(27.1)	69,146	(23,628)	(34.2)	12,728	1,475	11.6
Total	5,304,987	1,297,810	[2] 24.5	1,932,034	53,082	[2] 2.7	3,274,376	1,247,677	38.1

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[1] Percent (parenthetical indicates a negative rate).

[2] The average rate computed from this table differs from the Pease-Dorgan average rate. This difference is primarily due to the exclusion of loss companies from the Pease-Dorgan computations.

[3] Not disclosed, or not computed.

The U.S. tax rate for individual banks was either negative or varied over a relatively narrow positive range, from negative 205.7 percent (Crocker National, a refund on relatively low income) to 19.0 percent (J. P. Morgan & Co.). Only four banks (Chase Manhattan, J. P. Morgan & Co., Continental Illinois and Interfirst) showed U.S. tax rates on U.S. income greater than 8 percent. The worldwide tax rate on worldwide income varied over a broader range, from negative 27.1 percent (First Bank System) to 52.1 percent (Citicorp).

Table 3 also illustrates the source of income. For the 20 largest banks, 62 percent of their income was foreign source; for the 10 largest banks 72 percent was foreign source. For example, Citicorp had foreign source income of approximately $861 million, worldwide income of $779 million and a domestic loss of $82 million. Likewise Bankers Trust New York had $200 million in foreign income, $245 million worldwide income and domestic income of $45 million.

Large banks' effective tax rate of 24.7 on worldwide income is in large part due to the higher effective tax rates on foreign source income combined with the high percentage of total income that is foreign source. This has the effect of offsetting the low U.S. tax rate on U.S. income.

A comparison of the effective tax rates computed in the Pease-Dorgan Study with those in the Tax Notes Study and those disclosed in the corporate financial statements is shown in Table 4. The U.S. and foreign rates are not shown in financial statements and thus are not available for comparison.

First, in comparing the worldwide rates in the Pease-Dorgan Study with the rates in annual reports, it can be seen that, overall, the differences between these rates are relatively small. The average rate for the 20 banks is 27 percent in annual reports and 24.7 percent in the Pease-Dorgan Study. The main differences are attributable to the treatment of State and local income taxes (included in the annual report rate) and deferred taxes.

Second, the differences between the rates in the Pease-Dorgan Study and those in Tax Notes are more marked, with the rate in Tax Notes for almost every bank being lower. (The reasons for these differences are discussed more fully below.) The foreign tax rates in these studies are identical in many cases and very close in others. In Tax Notes the U.S. rate on U.S. income is negative in 11 out of the 19 banks which were included in the Tax Notes Study. The highest rate was J. P. Morgan & Co.'s rate of 7.9 percent, the only rate which was above 5 percent.

Since in the Pease-Dorgan Study deferred taxes and State and local taxes are excluded from the provision for income taxes, the effective tax rates are, as could be expected, generally lower than the effective tax rates disclosed in the financial statements. However, the effective tax rates computed by Tax Notes, which include a portion of deferred taxes, are generally even lower than the rates in the Pease-Dorgan Study. The reason for this somewhat unexpected result lies in the selection of timing differences that Tax Notes treats as quasi-permanent (and thus does not include in the tax rate) and those timing differences that result in deferred taxes that Tax Notes treats as actually paid.

Table 4.—Comparison of Effective Tax Rates for 20 Large Commercial Banks, 1981

Bank	Effective tax rates						
	Worldwide tax rate on worldwide income			U.S. tax rate on U.S. income		Foreign tax rate on foreign income	
	Annual report	Tax Notes	Pease-Dorgan study	Tax Notes	Pease-Dorgan study	Tax Notes	Pease-Dorgan study
Bank America	31.0	27.1	28.0	(15.4)	(11.7)	41.2	41.6
Citicorp	34.7	31.2	52.1	(2)	(2)	45.3	45.3
Chase Manhattan	26.9	18.1	34.7	(44.1)	14.9	31.6	40.2
Manufacturers Hanover Trust	33.2	16.4	29.3	(2)	(2)	24.4	25.1
J. P. Morgan & Co.	32.3	17.6	20.5	7.9	19.0	23.8	21.6
Continental Illinois	31.8	19.7	23.9	3.9	14.3	48.7	41.8
Chemical New York	27.9	4.7	23.9	(14.9)	3.2	65.2	55.0
First Interstate	11.0	3.2	7.4	1.0	5.8	15.4	15.4
Bankers Trust New York	24.0	7.6	25.1	(92.4)	(2.0)	30.6	31.2
First Chicago	18.3	11.1	15.5	(6.3)	.2	55.5	55.7
Security Pacific	37.6	5.5	9.0	(2.2)	2.3	46.9	46.9
Wells Fargo	21.0	(8.6)	12.1	(61.3)	5.3	20.1	15.9
Crocker National	9.6	37.2	12.2	(1,786.3)	(205.7)	41.0	41.0
Marine Midland	31.3	15.0	18.4	1.8	7.5	34.8	34.8
Mellon National	12.3	(4.4)	(18.0)	(22.6)	(38.8)	85.8	85.8
Irving Bank	28.2	11.9	12.5	.2	1.6	24.7	24.7
Interfirst	26.0	(1)	16.7	(1)	17.8	(1)	8.7
First National Boston	33.4	25.2	27.2	(23.8)	(23.9)	66.5	66.0
Northwest Bancorp	3.6	3.3	(3.0)	(1)	(1)	(1)	(1)
First Bank System	1.6	(16.4)	(27.1)	(20.6)	(34.2)	11.6	11.6

[1] Information not available or not disclosed.

[2] No rate is computed on book loss.

Timing differences treated as quasi-permanent by Tax Notes include accelerated depreciation primarily from leasing activities and some loan losses. These particular timing differences result in a deferred tax expense for most of the banks studied. Thus, the effect of excluding these items from the effective tax rate is a lower rate than that disclosed in financial statements, which is the same result as in the Pease-Dorgan Study. However, the Tax Notes rate is further reduced by the inclusion of timing differences which, in the case of those particular banks, result in a deferred tax credit (i.e., they reduce the overall tax rate). These timing differences either originated in an earlier period and are now reversing or result from transactions giving rise to income which is recognized for tax purposes sooner than it is for financial statement purposes. These timing differences appear to include some loan losses, cash to accrual adjustments, installment sales, undistributed earnings of foreign subsidiaries, foreign currency translation, foreign tax credits, investment tax credits and others.

Analysis of permanent differences

Table 5 shows the permanent differences identified in the reconciliation of effective tax rates to the statutory rate in the financial statements.

Clearly, the most significant permanent difference for banks is the interest received on State and local government obligations, which is included as income for financial accounting purposes but is excluded from taxable income. Tax exempt income reduced the effective tax rate by amounts which varied from 5.6 percent (Citicorp) to 47.3 percent (First Bank System). For fifteen of the twenty banks, the reduction in effective tax rates was greater than 15 percent.

Other permanent differences that affect banks are often grouped as "other" where each item included is not material by itself. These differences are in general similar to permanent differences for other corporations.

Reductions in tax rates from the statutory rate also arise from provisions in the tax rules which tax some income at a different rate than other income, or from income tax credits. Examples of income taxed at lower rates include the first $100,000 of taxable income, which is taxed at graduated rates below 46 percent. Additionally, income resulting in capital gains is taxed at a lower rate. Income tax credits include the investment tax credit, targeted jobs tax credit and others. Investment tax credits can result in a significant reduction of tax rates for any bank that is engaged in substantial leasing activities.

Table 5.—Reconciliation to Statutory Federal Income Tax Rate Per Financial Statements for 20 Large Commercial Banks, 1981

Bank	Statutory rate	Tax exempt income	Investment tax credit	Other	Effective tax rate per annual report[1]
Bank America	46.0	(7.0)	(6.0)	(6.0)	27.0
Citicorp	46.0	(5.6)	(2)	(7.0)	33.4
Chase Manhattan	46.0	(17.2)	(2)	(5.2)	23.6
Manufacturers Hanover Trust	46.0	(15.2)	(2)	(6.4)	24.4
J. P. Morgan & Co	46.0	(19.9)	(2)	(.5)	25.6
Continental Illinois	46.0	(13.1)	(2)	(2.9)	30.0
Chemical New York	46.0	(18.7)	(2)	(6.1)	21.2
First Interstate	46.0	(32.0)	(5.0)	(1.0)	8.0
Bankers Trust New York	46.0	(19.0)	(2)	(4.0)	23.0
First Chicago	46.0	(21.8)	(2.3)	(5.6)	16.3
Security Pacific	46.0	(6.0)	(5.3)	(2.2)	32.5
Wells Fargo	46.0	(14.4)	(6.9)	(3.7)	16.9
Crocker National	46.0	(23.9)	(16.4)	(1.4)	4.3
Marine Midland	46.0	(15.8)	(3.0)	(1.8)	25.4
Mellon National	46.0	(31.1)	(2)	(2.6)	12.3
Irving Bank	46.0	(18.9)	(2)	(4.8)	22.3
Interfirst	46.0	(18.6)	(.7)	(.7)	26.0
First National Boston	46.0	(16.6)	(.3)	(1.2)	27.9
Northwest Bancorp	46.0	(39.2)	(4.9)	(2.3)	(.4)
First Bank System	46.0	(47.3)	(3.0)	(2)	(4.3)

[1] Excludes portion attributable to State and local taxes.
[2] Not available or not disclosed.

In accounting for investment tax credits, special rules apply to financial institutions. A financial institution may include the investment tax credit as part of the proceeds from leased property accounted for by the financing method and include it in determining the yield from the loan, which is reflected in income over the term of the lease. Under this method of financial accounting for investment tax credits, the provision for taxes will not be decreased but, instead, income will be increased by the amount of the investment tax credits. Therefore, the effective tax rate calculations will show the bank paying more tax (but earning more income) than it actually does. However, the amount of investment tax credit amortized to lease income is not always disclosed; therefore, the distortion in effective tax rates due to this method of accounting for the investment tax credit cannot always be determined. Investment tax credits accounted for in this manner will not be reflected in the reconciliation to statutory rates.

When a bank purchases property for its own use, the investment tax credit on this property can reduce taxes for book purposes in the same year as for tax purposes (flow-through method) or over the life of the asset (deferral method). If the flow-through method is used, the investment tax credit will be reflected as a reduction in tax rate in the same manner as a permanent difference. If the deferral method is used, the amount deferred for book purposes will be reflected as a timing difference. Investment tax credits which are disclosed separately reduce the effective tax rate by as much as 16.4 percent (Crocker National).

Analysis of timing differences

Table 6 shows the timing differences identified in the analysis of deferred tax included in the financial statements. This section discusses some of the more significant of these timing differences.

Leasing.—First, some significant timing differences are attributable to the accounting for lease financing activities. Such timing differences arise primarily from the use of accelerated cost recovery for tax purposes and straight-line depreciation for financial accounting purposes. These timing differences generally result in a deferred tax expense (i.e., an expense treated as a current year's expense for book purposes although it will not actually be payable until some future date). To the extent that a financial institution increases leasing activities or there is inflation, these deferred taxes may be deferred indefinitely. However, if the leasing activities are reduced, these timing differences will reverse (deferred tax will be a credit), and the tax liability will be paid.

Table 6.—Analysis of Deferred Tax Per Financial Statements for 20 Large Commercial Banks, 1981

[Percent]

Bank	Effective tax rate per annual report [1]	Rate reduction due to deferred tax [2]						Deferral of State and local tax	Effective tax rate per Pease-Dorgan study
		Loan loss	Lease financing	Foreign	Accrual to cash [5]	ITC	Other [3]		
Bank America	27.0	(3.9)	(10.3)	3.2	([4])	11.7	(0.4)	0.7	28.0
Citicorp	33.4	8.9	(5.1)	6.3	2.6	([4])	6.0	(.3)	52.1
Chase Manhattan	23.6	.7	(3.9)	6.2	2.1	([4])	3.1	2.9	34.7
Manufacturers Hanover Trust	24.4	7.0	(10.2)	4.5	([4])	([4])	4.8	(1.2)	29.3
J. P. Morgan & Co.	25.6	2.5	(7.8)	([4])	([4])	([4])	(5.3)	5.5	20.5
Continental Illinois	30.0	3.8	(5.1)	([4])	([4])	(5.8)	.9	.1	23.9
Chemical New York	21.2	1.5	(6.5)	([4])	4.2	([4])	5.1	(1.6)	23.9
First Interstate	8.0	3.7	(6.4)	([4])	3.8	([4])	.3	(2.0)	7.4
Bankers Trust New York	23.0	(.7)	(14.0)	([4])	([4])	([4])	15.3	1.5	25.1
First Chicago	16.3	(6.7)	(5.9)	([4])	3.0	[6] 9.0	(2.2)	2.0	15.5
Security Pacific	32.5	(2.2)	(24.7)	([4])	([4])	3.6	(3.9)	3.7	9.0
Wells Fargo	16.9	5.7	(20.6)	([4])	16.4	([4])	(7.7)	1.4	12.1
Crocker National	4.3	11.7	(30.8)	([4])	(30.5)	[6] 52.8	(3.7)	8.4	12.2
Marine Midland	25.4	2.8	(5.6)	([4])	([4])	(2.7)	(1.6)	.1	18.4
Mellon National	12.3	(13.4)	(10.1)	([4])	.4	([4])	(7.2)	([4])	(18.0)
Irving Bank	22.3	1.8	(8.5)	([4])	([4])	([4])	(5.2)	2.1	12.5
Interfirst	26.0	(1.1)	(4.8)	([4])	([4])	([4])	[7] (3.4)	([4])	16.7

Table 6.—Analysis of Deferred Tax Per Financial Statements for 20 Large Commercial Banks, 1981

[Percent]

Bank	Effective tax rate per annual report [1]	Rate reduction due to deferred tax [2]						Deferral of State and local tax	Effective tax rate per Pease-Dorgan study
		Loan loss	Lease financing	Foreign	Accrual to cash [5]	ITC	Other [3]		
First National Boston	27.9	4.5	.2	(6.3)	4.4	([4])	(2.8)	(.7)	27.2
Northwest Bancorp	(.4)	.4	(7.4)	7.6	([4])	([4])	(5.5)	2.3	(3.0)
First Bank System	(4.3)	1.7	(7.7)	([4])	([4])	([4])	[7] (20.6)	3.8	(27.1)

[1] Excludes portion attributable to State and local taxes.

[2] A deferred income/expense item which reduces the current year's tax liability is shown as a reduction in effective rates (negative amount) in the above table.

[3] Includes adjustments to income and tax expense made in the Pease-Dorgan Study. For an explanation of these adjustments, see Methodology and Appendix A in Pease-Dorgan Study.

[4] Not available.

[5] Includes amounts attributable to different methods of accounting for book and tax purposes.

[6] Includes foreign tax credit carryovers.

[7] Adjustment includes effect of tax refund attributable to securities losses (not included in annual report effective rate).

Nineteen of the twenty large banks benefited from the deferrals due to lease financing. The resulting reduction in effective tax rates ranged from 30.8 percent (Crocker National) to 3.9 percent (Chase Manhattan). Seven banks (Bank America, Manufacturers Hanover Trust, Bankers Trust New York, Security Pacific, Wells Fargo, Crocker National, and Mellon National) reduced their effective tax rates by more than 10 percent due to their leasing activities.

Loan-loss reserves.—Second, other timing differences are attributable to the provision for losses on loans. Under generally accepted accounting principles, the convention of conservatism requires that, when assets are measured in a context of significant uncertainties, possible errors in measurement should be in the direction of understatement. Thus, the reserve for losses on loans is based on an evaluation of anticipated loan losses. The methods used to compute loan loss reserves for tax purposes generally do not result in the same addition to a reserve for loan losses as that computed for accounting purposes. Thus, the bad debt expense is allowed as a deduction in different years for book and for tax purposes, giving rise to timing differences.

For some of the banks included in the Pease-Dorgan Study, the bad debt deduction allowed for taxes was higher than that allowed for book purposes, giving rise to a deferred tax expense which reduced the current year's income tax liability. The amount of the reduction ranged from 13.4 percent (Mellon National) to 0.7 percent (Bankers Trust New York). For other banks, the bad debt deduction allowed for tax purposes was lower than that allowed for book purposes, giving rise to deferred taxes which reflect a higher current year's tax liability than book liability. Effective tax rates were increased by 11.7 percent (Crocker National) to 0.4 percent (Northwest Bancorp).

Typically, in years prior to 1981 the additions to the loan loss reserves for book purposes were lower than those allowed for tax purposes. In those years banks had the benefit of the tax deferral. More recently, during a period of economic uncertainty, the additions to the loan loss reserves for book purposes, determined under management's best judgement of expected loan recovery rates, have often been greater than the amounts allowed for tax purposes.

Foreign items.—Third, some timing differences are attributable to foreign operations. These include the undistributed earnings of foreign subsidiaries, foreign currency translation and foreign tax credits.

Deferred taxes need not be provided on undistributed earnings of subsidiaries when sufficient evidence shows that the subsidiary has invested, or will invest, the undistributed earnings indefinitely or that earnings will be remitted in a tax-free liquidation. In this case, the books reflect the deferral of taxes that exists under the tax rules as a permanent difference. However, if the earnings are not deemed to be invested indefinitely, deferred taxes must be provided.

Foreign currency translation gains or losses may be included in income, and foreign tax credits may be recognized, for financial statement purposes in a different period than for tax purposes.

Deferred taxes attributable to foreign operations of banks included in the Pease-Dorgan Study have been grouped together (see Table 6). In total, the change in effective tax rates ranged from a decrease in rate of 6.3 percent (First National Boston) to an increase in rate of 7.6 percent (Northwest Bancorp). Overall, these items do not have a major impact on the effective tax rates.

Method of accounting.—Fourth, some timing differences are attributable to a taxpayer using the accrual method of accounting for book and the cash method of accounting for tax purposes. Some large, and many smaller, financial institutions use the cash method of accounting for tax purposes.

Accrual-to-cash timing differences arise when items of income or expense are recognized or allowed as a deduction in different periods. In general, many of these timing differences originate in one period and reverse in the next period. While in aggregate accrual-to-cash timing differences may provide some deferral of tax, this deferral is not generally an indefinite deferral such as the deferral attributable to accelerated cost recovery.

Other differences.—Fifth, all other timing differences are grouped together. Each timing difference included may not be material by itself. For purposes of Table 6, the adjustments made in the Pease-Dorgan Study are also grouped with "other differences". These adjustments were needed primarily to ensure that the accounting entity was comparable with the tax entity because the accounting rules for grouping corporations together are not the same as the tax rules. On average, the impact of these adjustments on the effective tax rate was not material.

C. Significance of Effective Tax Rates

The previous section noted a number of unresolved issues that arise in trying to measure the effective tax rates of commercial banks from data in financial statements. Apart from these somewhat technical questions, there are some more fundamental questions about the significance of the resulting measures of effective tax rates.

Perceptions of tax equity

One issue that arises when an industry pays relatively low effective tax rates is that individuals may conclude that the tax system is not equitable. This may cause them to reduce their own level of compliance with the tax laws, avail themselves of more opportunities to make tax-sheltered investments, urge their legislators to enact countervailing tax preferences for themselves, or simply cause the American people to lose faith in the political process. These perception problems may be particularly acute when an industry is highly visible, like the banking industry, and is an industry whose interactions with the citizenry are sometimes adverse (e.g., loan foreclosures and high interest costs for loans).

True burden of taxation

One deficiency of the effective tax rate concept is that it does not distinguish between the income tax burden imposed directly on a taxpayer (in the case of the banks, a relatively modest burden in 1981) and the ultimate economic burden that the income tax places on a person. The economic burden of the income tax on banks is considerably higher than the actual tax they owe. The reason for this is that many of the tax-preferred investments made by banks, including equipment leases and tax-exempt bonds, yield lower pre-tax rates of return than do fully taxable but otherwise comparable investments. This lower pre-tax rate of return constitutes a burden attributable to the income tax on banks that is not reflected in effective tax rate measures based on taxes actually paid.

The extent to which this indirect burden causes the total burden on banks to approach the 46-percent statutory tax rate depends on the difference between the after-tax yields of tax-preferred investments and fully taxable investments. If the difference in after-tax yields is small, it indicates that the banks bear close to the full economic burden of the income tax with respect to the tax-preferred investments.

For some tax-preferred investments, this appears to be the case. For example, in the case of tax-exempt bonds with relatively short maturities, interest rates are sufficiently lower than on comparable taxable bonds that the after-tax return on the tax-exempt bonds is not appreciably higher. Thus, even though holders of these bonds pay no tax on the income, they bear a burden comparable to the full 46-percent income tax. In effect, the banks in this case are relatively efficient conduits through which the federal government routes its assistance for short-term borrowing by State and local governments.

However, the issue is more clouded in the case of longer-term tax-exempt bonds. The interest rates on these bonds in recent months have been 75 to 85 percent of those on comparable taxable bonds, so that banks have earned a higher after-tax rate of return on them than on taxable bonds. (The tax-exempt interest rate would have to be 54 percent of the taxable rate for the banks to be bearing a full 46-percent indirect burden.) Thus, with respect to these investments, the banks bear some burden but considerably less than the full 46 percent. In effect, the banks are a conduit through which the federal government routes its subsidy for long-term borrowing to State and local governments and other beneficiaries of tax-exempt financing, but they are a relatively inefficient conduit. For example, at an interest rate ratio of 80 percent, the issuing government receives only 43 percent of the federal interest subsidy and the banks receive 57 percent.

The other principal area in which the banks act, in effect, as conduits for the delivery of federal assistance through the tax system is equipment leasing. It is widely known that leasing enables some of the value of tax benefits to be passed through to lessees through lower lease rentals; however, unlike the situation with tax exempt bonds, no data are available on what fraction of the benefits are passed through. (A Joint Committee staff study on safe-harbor leasing[1] concluded that 77 percent of the benefits were passed through to lessees, but no comparable study is available for ordinary leasing.)

Reserve requirements

The banks argue that their actual tax payments understate the contribution they make to federal budget receipts because the Federal Reserve System earns interest on reserves which banks and thrift institutions are required to keep at the Fed. The Fed pays no interest on these reserves, and when the Fed deposits its earnings at the Treasury, the budget records additional budget receipts. However, others argue that reserve requirements, to the extent they can be considered analogous to a tax, are closer to an excise tax than to an income tax and, therefore, should not be counted as a component of an effective income tax rate. Furthermore, it is argued that many businesses have to deal with government regulations and that discussions of effective tax rates would be confused if adjustments were made for the burden of such regulations (e.g., the effect of natural gas price controls on the oil and gas industry).

Allocation of resources

Some have argued that the low effective tax rates paid by banks provide an incentive for the economy to invest too much of its limited stock of capital in the banking industry, as opposed to investing in other kinds of industries. However, it would be very difficult to quantify this effect.

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[1] "Analysis of Safe Harbor Leasing," a report by the staff of the Joint Committee on Taxation, June 14, 1982 (JCS-23-82).

III. SPECIFIC TAX LAW PROVISIONS

A. Bad Debt Reserves

Present Law

General tax rules

Under present law, taxpayers are permitted a deduction for any debt which is acquired or incurred in the taxpayer's trade or business which becomes wholly or partially worthless during the taxable year. This deduction may be computed under either of two methods. Under the "specific charge-off method" specific bad debts may be deducted in the year in which they become worthless or partially worthless. Under the "reserve method" a deduction is permitted, at the discretion of the Secretary, for a reasonable addition to a reserve for bad debts. When debts are determined to be totally or partially worthless, no deduction is allowed, but the amount of the bad debt is charged against the reserve (i.e., the reserve is reduced). The taxpayer's method of computing the annual addition to the bad debt reserve will allow him to deduct an amount needed to increase the reserve to the appropriate level. The reasonableness of an addition to a reserve for bad debts depends upon the facts and circumstances of the particular case as they exist at the close of the taxable year of the proposed addition to the reserve. The courts have generally permitted taxpayers to determine the reasonable addition to the reserve for bad debts under a formula similar to the experience method for banks, described below.

Commercial banks

Commercial banks may use several methods of computing bad debt reserves. A commercial bank is allowed a deduction for an annual addition to its loan loss reserves[1] equal to the greater of the amounts computed under either the "experience" or "percentage of eligible loan" method.[2]

Experience method.—Under the experience method, the addition to the reserve for bad debts is generally an amount necessary to increase the loan loss reserve at the close of the taxable year to a percentage of total loans outstanding equal to the average ratio of total bad debts in the current and 5 preceding taxable years to the sum of loans outstanding at the close of these years. However, if it leads to a larger loss reserve, the annual allowable addition is the amount necessary to increase the balance of the loan loss reserve to the balance of the reserve at the close of the base year (or if the total amount of loans outstanding at the close of the taxable year is less than the loans outstanding at the close of the base year, a proportionate part of the loans outstanding at the close of the taxable year). Presently, the base year is the last taxable year before the most recent adoption of the experience method. Taxpayers may use an averaging period shorter than 6 years with the approval of the Treasury, which may be given in the cases where the taxpayer can demonstrate that there has been a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased.

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[1] Unlike the funded reserve that many financial institutions are required to maintain under the auspices of various regulatory bodies, a reserve for bad debts for tax purposes consists simply of accounting entries in the institution's books and records (i.e., it is not a funded reserve of cash or other liquid assets available to offset the impact of unexpected losses).

[2] Commercial banks also are permitted to use the specific charge-off method in lieu of the reserve method. However, few banks presently use the specific charge-off method.

After 1987, commercial banks are required to compute the deduction for additions to the reserve for bad debts solely under the experience method (or specific charge-off method).

Percentage of eligible loans method.—Under the "percentage of eligible loans" method, an addition to the reserve for bad debts is allowable in an amount sufficient to increase the loan loss reserve at the close of the taxable year to a specified percentage of the eligible loans at the close of the taxable year.[3] The specified percentage was 1.0 percent for 1982 and is 0.6 percent for 1983 through 1987. Thus, in the case of a bank whose eligible loan portfolio is expanding and which starts the year with a 0.6-percent bad debt reserve, the deduction for the addition to the bad debt reserve in a typical year will be the actual bad debt losses charged against the reserve during that year plus 0.6 percent of the increase in eligible loans during the year.

As is the case under the experience method, commercial banks utilizing the percentage of eligible loans method are permitted, at a minimum, a deduction sufficient to restore the balance in the loan loss reserve at the close of the taxable year to its base-year level so long as eligible loans have not decreased below their base-year level.[4] If eligible loans have decreased below their base-year level, the minimum bad debt deduction permitted the bank will be reduced proportionately.[5] In addition, the maximum addition to the reserve for losses on loans under the percentage method cannot exceed the greater of 0.6 percent of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve for losses on loans to 0.6 percent of eligible loans at such time.

A commercial bank may switch between methods of determining the addition to its reserve for losses on loans from one year to another. Further, a commercial bank need not adopt a method yielding the largest deduction, although the regulations do prescribe minimum deductions.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been an allowable deduction on the basis of actual experience, the allowable bad debt reserve deduction for the taxable year is reduced by 15 percent of the excess. Further, 71.6 percent of the excess is an item of tax preference under the minimum tax.

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[3] For purposes of the percentage computation, the term "eligible loans" generally means loans incurred in the course of the normal customer loans activities of the financial institution, on which there is more than an insubstantial risk of loss. In determining the allowable addition to reserves under the experience method, there is no requirement that the computation be based on eligible loan balances.

[4] For purposes of the percentage of eligible loans method, after 1982 the base year will generally be 1982.

[5] There is a further limitation that reduces the bad debt addition when the base-year loss reserve is less than the allowable percentage of base-year loans.

Thrift institutions

Under present law, thrift institutions (mutual savings banks, domestic building and loan associations, savings and loan associations, and cooperative banks without capital stock) are granted more favorable tax treatment in the computation of their bad debt deductions than that generally allowed to other taxpayers. Presently, thrift institutions are allowed to compute the deductible additions to their bad debts reserves under modified versions of either of the two methods available to commercial banks (i.e., the experience method or the percentage of eligible loans method), or under the "percentage of taxable income" method. They may also use the specific charge-off method.

In determining the amount of an allowable loan loss deduction, special rules apply with respect to "qualifying real property loans" and "nonqualifying loans." In general, a qualifying real property loan is any loan secured by an interest in improved real property or secured by an interest in real property that is to be improved out of the proceeds of the loan, A nonqualifying loan is any loan which is not a qualifying real property loan.

Experience method.—Under the experience method, a thrift institution is allowed a deduction equal to a reasonable addition to its loan loss reserve, determined under the experience method applicable to commercial banks.

Percentage of eligible loans method.—Under the percentage of eligible loans method, a thrift institution is allowed an addition to its loan loss reserve for losses on qualifying real property loans computed in the same manner as the addition for losses on eligible loans is computed for commercial banks plus the allowable addition to the loan loss reserve for nonqualifying loans computed under the experience method. However, the overall loss reserve is limited to the larger of (1) the amount determined under the experience method applicable to commercial banks, or (2) an amount which equals the excess of 12 percent of total deposits or withdrawable accounts of depositors at the close of the taxable year over the sum of the institution's surplus, undivided profits and reserves at the beginning of such taxable year. (This limit applies to the percentage of taxable income method as well.) In effect, thrift institutions using the percentage methods may not build up a loan loss reserve such that their loan loss reserve plus their surplus exceeds 12 percent of deposits. Thrift institutions which have little or no taxable income usually elect this method of computing their bad debt reserves.

Percentage of taxable income method.—Under the percentage of taxable income method, a thrift institution is allowed a deduction for additions to its loan loss reserve for qualifying real property loans equal to 40 percent of its "taxable income" for the taxable year.[6] A variety of limitations are, however, placed on this addition. First, the percentage of taxable income which may be deducted under this method (presently 40 percent) is reduced by ¾ percentage points for each percentage point by which "qualifying assets" fall short of 82 percent of total assets (1½ percentage points for each percentage-point shortfall below 72 percent in the case of a mutual savings bank without stock).[7] Second, the percentage-of-taxable-income method is not applicable at all if less than 60 percent of the institution's total assets are invested in qualifying assets. Third, the amount determined under the percentage of taxable income method must be reduced by a proportional amount of the loan loss reserve addition for that taxable year determined under the experience method with respect to nonqualifying loans. Fourth, the addition to the reserve for qualifying real property loans may not exceed the amount necessary to increase the balance of such reserve at the close of the taxable year to 6 percent of such loans outstanding at the close of the taxable year. Finally, the overall bad debt reserve addition cannot exceed the greater of (1) the amount determined under the experience method described above for commercial banks, or (2) the excess of 12 percent of total deposits or withdrawable accounts of depositors at the close of the taxable year over the sum of surplus, undivided profits, and reserves at the beginning of the taxable year.

As in the case of commercial banks, the excess of the amount allowable to the thrift institution as a reasonable addition to its bad debt reserve for the taxable year, over the amount that would be allowable for that taxable year had the institution maintained its reserve on the basis of actual experience for all taxable years, is a financial institution preference item. As such, 15 percent of the excess is nondeductible and 71.6 percent of such excess is an item of tax preference subject to the minimum tax.

Because the effect of the percentage of taxable income method is to subject thrift institutions to tax only on part of their income, limitations are imposed upon some of the deductions and credits of thrift institutions. First, thrift institutions are entitled to only one-half of the investment tax credit available to other taxpayers generally. Second, thrift institutions are entitled to only one-half of the targeted jobs tax credit available to other taxpayers generally. Finally, although corporations generally are entitled to a deduction of 85 percent (100 percent in certain circumstances) of all dividends received from domestic corporations, thrift institutions must reduce the amount of this deduction by 40 percent. These provisions that deny tax benefits to thrift institutions apply regardless of whether the institutions actually use the percentage-of-taxable-income method and are independent of the amount of the benefit they receive from use of that method.

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[6] The term "taxable income" is defined for this purpose to mean taxable income computed by excluding amounts recaptured by thrift institutions out of excess loan loss reserves, without regard to amounts deductible as an addition to the bad debt reserve, by excluding from gross income amounts of net gain on the sale or exchange of corporate stock or tax-exempt bonds, by excluding 18/46 of other net long-term capital gains and by excluding intercorporate dividends received to the extent a deduction is allowable.

[7] "Qualifying assets" for this purpose are: (a) cash, (b) taxable Government obligations, (c) obligations of State-chartered organizations which are organized to insure deposits or share accounts of member associations, (d) share loans, (e) loans for residential real property, including real property primarily used for church purposes, facilities in residential developments dedicated to public use (e.g., schools and libraries), and property used on a nonprofit basis by residents (e.g., swimming pools, etc.) and mobile homes not used on a transient basis, (f) loans for the improvement of commercial or residential property in an urban renewal area or in an area eligible for assistance under the Demonstration Cities and Metropolitan Development Act, (g) loans for educational, health and welfare institutions or facilities including facilities primarily for students, residents, etc., (h) property acquired through the liquidation of any of the prior three categories, (i) student loans, and (j) property used by the thrift institution in its business.

Legislative History

Commercial banks

Prior to 1969, bad debt reserves of commercial banks were determined under administrative rulings. Prior to 1965, banks were allowed to accumulate a reserve of up to three times the 20-year average of their losses as a percentage of loans. In 1965, the Treasury Department granted banks the privilege, on an industry-wide basis, of building up a bad-debt reserve equal to 2.4 percent of eligible loans.

The Tax Reform Act of 1969 established the basis of the present system of computing bad debt reserves of commercial banks. The percentage of eligible loans method was phased out over an 18-year period. At that time, it was asserted that bad debts averaged only about 0.2 percent of outstanding noninsured loans.

In the Economic Recovery Tax Act of 1981, the phase-down of the percentage from 1.2 to 0.6 was delayed from 1982 to 1983, and a percentage of 1.0 established for the year 1982. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the excess bad debt reserve deduction of both banks and thrift institutions by 15 percent as part of an across-the-board cutback in tax preferences.

Thrift institutions

Savings and loan associations, cooperative banks and mutual savings banks were tax exempt until the Revenue Act of 1951. While thrift institutions were made taxable as part of that Act, they were also given generous bad debt deductions that kept their taxes to a small fraction of income. In the Revenue Act of 1962, Congress attempted to end this virtual tax exemption by modifying the bad debt reserve deductions.

The system set up in 1962 allowed thrift institutions to choose among two alternative formulas: (1) an annual addition to reserves of 60 percent of taxable income (limited to a loss reserve of 6 percent of qualifying real property loans), or (2) a loss reserve of 3 percent of qualifying real property loans plus a percentage of other loans based on experience. Savings and loan associations and cooperative banks were allowed to use these methods only if 82 percent of their assets were invested in residential real estate, liquid assets and certain other assets, but no similar restrictions were applied to mutual savings banks.

The basis of the present system was set up by the Tax Reform Act of 1969, which eliminated the 3-percent method, phased down the percent of taxable income from 60 to 40 percent over 10 years, applied limits on the use of the percentage of taxable income method to mutual savings banks similar to those applicable to savings and loan associations (but with a 72-percent qualifying asset requirement in place of 82 percent), provided that the taxable income percentage was to be phased down gradually if an institution's proportion of qualifying assets fell short of 82 or 72 percent (instead of causing that institution to lose all benefit from the percentage of taxable income method), and made a series of other modifications to the bad debt provisions.

The Economic Recovery Tax Act of 1981 expanded the organizations eligible for these special rules to include stock savings banks. The rules applicable to stock savings banks are the same as those applicable to savings and loan associations.

Issues

The principal policy issues related to the bad debt reserves of financial institutions can be grouped under two headings: (1) what treatment of bad debts provides an accurate measure of a taxpayer's income, and (2) to the extent that Congress wants to provide deductions in excess of those needed to measure income in order to achieve some nontax policy objectives, what treatment of bad debts would best carry out Congressional intent?

Income measurement

Since 1921, all businesses have been allowed to deduct additions to bad debt reserves; that is, to accumulate a bad debt reserve out of pre-tax, rather than after-tax, income. The argument that the reserve treatment of bad debts (as opposed to the specific charge-off method) contributes to proper income measurement runs essentially as follows: When a business makes sales that are reflected in accounts receivable, and reports the sales as taxable income, it knows that statistically a certain percentage of those receivables are likely to become bad debts. According to the principles of accrual basis accounting, the cost of the bad debts is allocable to, and properly deductible against, the sales which generated those receivables, and thus some estimate of their cost should be deducted as an addition to bad debt reserves when the income from the sales is reported. When actual defaults occur, under this theory the bad debts should first be charged against the bad debt reserve and should only be deductible to the extent they exceed the amount previously deducted as an addition to the bad debt reserve.

Under present law, a widely accepted method of determining a reasonable addition to a reserve for bad debts is an experience method as described in the case of *Black Motor Co.*[8] The *Black Motor Co.* case adopted a six year moving average method for determining a business' addition to its bad debt reserve. This rule generally was adopted statutorily as one method for determining a financial institution's annual addition to its loan loss reserve.

There has been criticism of the *Black Motor Co.* method as it applies to an ordinary business because it only produces the theoretically correct reserve addition (i.e., the amount that would be deductible according to the principles of accrual accounting stated above) under a rather strict set of assumptions, the principal ones being that losses are charged off promptly, future losses equal a 6-

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[8] *Black Motor Co., Inc. v. Commissioner,* 41 B.T.A. 300 (1942); see, *Thor Power Tool Co., v. Commissioner,* 439 U.S. 522 (1979).

year moving average of past losses, and that receivables turn over once a year.[9] Suggestions have been made on how the experience method might be adjusted to deal with some of these problems. These include mechanical adjustments to the formula to adjust for turnover, as well as making it easier for taxpayers to make a "facts and circumstances" showing that their 6-year moving average loss rate is not a good estimate of future losses. It is not clear, however, that bad debt deductions for most ordinary businesses are sufficiently important to warrant the complexity associated with fine-tuning the Black Motor formula.

Some banks have argued that these same principles should apply to accounting for their bad debts but that bad debts are so important for their business that the deficiencies of the experience method should be corrected, such as by permitting more liberal use of "facts and circumstances" deviations from the 6-year moving average formula. Alternatively, it has been suggested that Congress set up a sufficiently generous statutory formula, such as 1.0 percent of eligible loans. Banks have argued that a one-percent formula would approximate the size of bad debt reserves for book purposes in recent years.

However, the application of accrual accounting principles to banks does not necessarily lead to the conclusion that their bad debt reserves should be computed under the formula that theoretically should be applicable to the accounts receivable of an ordinary business. Consider, for example, a bank that makes 100 loans, each amounting to one dollar and each maturing in 3 years. Assume that it anticipates that 5 percent of the loans will not be repaid, and it charges sufficiently high interest rates on all 100 loans to make them profitable despite the 5-percent expected default rate. One interpretation of the principles of accrual accounting is that the $5 bad debt expense be spread over the period during which the income from the loans will be earned; that is, one-third of it should be approximated by some type of bad debt reserve deduction each year. This is not the same as the formula appropriate for the receivables of an ordinary business. The difference is that the creation of receivables is usually the by-product of an event that produces taxable income against which all the bad debt losses from those receivables should be matched in an accrual method of accounting. Banks, however, generate bad debts from lending, and it is the interest from the loans that is the income against which bad debt losses should be matched, not the loans themselves. However, others argue that a more conservative treatment of expected bad debt losses is more appropriate for the banking industry, such as accounting for the entire expected bad debt loss in the year the loan is made. The issue of how best to determine an experience-based bad debt reserve is a complicated one, and Congress may want to study possible technical modifications of the present experience method prior to its becoming the required method for banks in 1988.

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[9] Assume, for example, that a business sells $100 of goods per year and generates $100 of receivables per year, $95 of which are paid after one year and $5 of which are bad debts. Under present law, the taxpayer will be able to build up a bad debt reserve equal to $5, the theoretically correct amount. Suppose, however, that receivables turn over twice a year (i.e., sales of $200 per year with receivables paid every 6 months), in which case bad debt losses will be $10 each year but outstanding debts at yearend will still be $100. Under the experience method, the taxpayer will be allowed to accumulate a bad debt reserve equal to 10 percent of receivables ($10 annual average losses divided by $100 annual average yearend receivables), or $10. This clearly exceeds the theoretically correct amount, which is still 5 percent of receivables, or $5. Conversely, the experience method leads to too small a reserve when receivables turn over less frequently than once a year. For examples on how the experience method produces incorrect results in other cases, see Whitman, Gilbert and Picotte, "The Black Motor Bad Debt Formula: Why It Doesn't Work and How to Adjust It," *Journal of Taxation*, December 1971.

There are a number of other possible ways to approach the question of what treatment of bad debts best measures income. Some have argued that a financial institution's bad debt deductions should be structured so as to make it indifferent, from a tax standpoint, between insuring its loans against risk (e.g. through a mortgage insurance company) and assuming the risk of loss itself. Others have argued that the tax rules should be structured so that the present value of the deductions is no different than that under the specific charge-off method. Still others have argued that the system should correspond to a mark-to-market system, under which taxpayers deduct the decline in the fair market value of their loan portfolio each year.

One difference between a bad debt reserve formula based on experience and one based on a statutory percentage of eligible loans is that the experience method provides larger loss reserves to banks engaging in relatively risky loans (e.g. consumer loans or loans to troubled businesses).

Bad debt reserves as a tax expenditure

The present percentage of taxable income method for savings and loan associations, cooperative banks and mutual savings banks was designed to serve a nontax purpose—encouraging these institutions to specialize in residential mortgage lending and certain other specified types of lending (see footnote 7 above). Thus, the method is available only to institutions which maintain 60 percent or more of their assets in qualifying assets and is phased down to the extent that less than a certain percentage of assets consists of qualifying assets.

The present system, however, does not appear to be well designed as an incentive for residential mortgage lending. Commercial banks and investors other than thrift institutions, which are excluded from the percentage of taxable income method, are given no tax incentive to engage in mortgage lending. Savings and loan associations and mutual savings banks fewer than 60 percent of whose assets qualify as residential mortgages or other types of qualifying assets also have no incentive to increase their mortgage lending, nor do thrift institutions whose qualifying assets exceed 82 percent of total assets (72 percent for mutual savings banks). The 10-point difference in the asset requirement between savings and loan associations and mutual savings banks appears to create an uneven playing field for competition between these institutions. Also, the present system encourages thrift institutions to specialize in mortgage lending (at least up to the 82- and 72-percent levels) which goes against recent trends in financial regulation that have attempted to encourage greater diversification. In past years, there have been recommendations to replace the percentage of taxable income method with some sort of generalized tax incentive for mortgage lending. The thrift institutions argue that the definition of qualifying assets ought to be broadened to include consumer loans and other assets for which the thrift institutions are being given new lending powers, or that the 82- and 72-percent thresholds be reduced.

One consequence of computing the addition to bad debt reserves as a percentage of taxable income is that the marginal tax rate of the typical thrift institution is only 60 percent of the statutory tax rate (i.e., 27.6 percent insted of 46 percent). This gives thrift institutions an incentive to invest in assets that generate taxable income; consequently, their holdings of tax-exempt bonds and their participation in equipment leasing tends to be small, unlike commercial banks.

A second argument for allowing financial institutions to have bad debt reserves in excess of those needed for a proper measurement of income is that federal regulations require that they maintain a certain percentage of their assets in zero or low-yielding assets as reserves or liquidity requirements. Excess bad debt reserves, especially those measured as a percentage of assets, enable financial institutions to build up some of their reserves or liquidity requirements out of pre-tax income, partially compensating them for the burden of the regulations.

Finally, it is argued that recent years have been particularly difficult for thrift institutions and that the national economy has an interest in maintaining the solvency of those institutions. This goal, it is argued, is promoted by generous deductions for additions to bad debt reserves.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Bonds

Present Law

Overview

Present law disallows the deduction of interest payments on indebtedness incurred to purchase or carry tax-exempt obligations. Under a long-standing judicial and administrative interpretation, bank deposits are not considered to have been accepted for the purpose of acquiring or holding tax-exempt obligations. Thus, a bank may invest deposited funds in tax-exempt obligations while continuing to receive a deduction for the full amount of interest it pays to its depositors. By contrast, individuals and most non-banking corporations which incur debts prior or subsequent to the purchase of tax-exempt obligations, without an independent business or personal reason for doing so, are considered to have incurred the debts for the purpose of acquiring or holding the tax-exempt obligations. These taxpayers are denied an interest deduction to the extent they have used borrowed funds to acquire or hold the tax-exempts.

The law regarding corporate preference items, added in 1982, reduces by 15 percent the amount of the deduction allowed to financial institutions for interest on debt allocable to tax-exempt obligations.

Statutory provisions

Section 163(a) of the Internal Revenue Code allows as a deduction all interest paid or accrued within the taxable year on indebtedness. Banks generally are permitted to deduct interest payments made to customers on amounts maintained as deposits.

Section 265(2) of the Code provides that no deduction shall be allowed for interest incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income tax.[1]

Section 291(a)(3) of the Code, added in 1982, reduces by 15 percent the amount allowable as a deduction with respect to certain financial institution preference items. These preference items include interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations, to the extent a deduction would otherwise be allowable for such interest.

The law as generally applied

The Internal Revenue Service and the courts have consistently interpreted the law to disallow an interest deduction only upon a showing that a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations.[2] They have employed various tests to determine whether a taxpayer has the prohibited purpose. In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings. When no such independent purpose exists, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed.[3]

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[1] The provision also disallows a deduction for interest incurred to purchase or carry any certificate to the extent the interest on such certificate is excludable under section 128 (all-savers certificates).

Illinois Terminal Railroad Co. v. *United States,* 179 Ct. Cl. 674, 375 F.2d 1016 (1967), disallowed a deduction for interest on a debt originally incurred for an independent business purpose, when the debt was continued for the purpose of allowing the taxpayer to carry tax-exempt bonds. The court held that the taxpayer lacked "purity of purpose" in continuing its debt.

Similarly, *Wisconsin Cheeseman, Inc.* v. *United States,* 388 F.2d 420 (7th Cir. 1968), denied an interest deduction to a corporation which took out short-term bank loans to meet recurrent seasonal needs for funds, pledging tax-exempt securities as collateral. The court held that the taxpayer could not automatically be denied a deduction because it had incurred indebtedness while holding tax-exempt obligations. However, use of the securities as collateral established a "sufficiently direct relationship" between the loans and the purpose of carrying tax-exempt securities. The court stated further that a deduction should not be allowed if a taxpayer could reasonably have foreseen, at the time of purchasing tax-exempts, that a loan would probably be required to meet ordinary, recurrent economic needs.

In Rev. Proc. 72-18, 1972-1 C.B. 740, the Internal Revenue Service provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, business enterprises that are not dealers in tax-exempt obligations, and banks in situations not dealt with in Rev. Proc. 70-20, 1970-2 C.B. 499.[4] The revenue procedure sets forth the general rule that a deduction will be disallowed only where the indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt securities. Accordingly, the application of the law requires a determination based on all the facts and circumstances as to the taxpayer's purpose in incurring or continuing each item of indebtedness. This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations also exists where the proceeds of indebtedness are directly traceable to the purchase of tax-exempts. Direct evidence of a purpose to carry tax-exempt obligations also exists when such obligations are used as collateral for indebtedness, as in *Wisconsin Cheeseman* above. In the absence of direct evidence, a deduction will be disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations. A deduction generally will not be disallowed for interest on an indebtedness of a personal nature (*e.g.* residential mortgages) or indebtedness incurred or continued in connection with the active conduct of an active trade or business.

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[2] Legislative history indicates that Congress intended the purposes test to apply. *See, e.g.*, S. Rep. No. 617, 65th Cong., 3d Sess. 6-7 (1918); S. Rep. No. 398, 68th Cong., 1st Sess. 24 (1924); S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

[3] *See generally Phipps* v. *United States,* 188 Ct. Cl. 531, 414 F. 2d 1366 (1969); *Bishop* v. *Comm'r,* 342 F. 2d 757 (6th Cir. 1965), *aff'g* 41 T.C. 154 (1963).

[4] Rev. Proc. 70-20 is discussed in the section concerning the law as applied to banks.

Under Rev. Proc. 72-18, when there is direct evidence of a purpose to purchase or carry tax-exempt obligations, no part of the interest paid or incurred on the indebtedness (or on that portion of the indebtedness directly traceable to the holding of particular tax-exempt obligations) may be deducted. In any other case, an allocable portion of interest will be disallowed. This amount is to be determined by multiplying the total interest on the indebtedness by the ratio of the average amount during the taxable year of the taxpayer's tax-exempt obligations to the average amount of his total assets.

Rev. Proc. 72-18 provides specifically that dealers in tax-exempt obligations are denied an interest deduction when they incur or continue indebtedness for the purpose of holding tax-exempt obligations. When dealers incur or continue indebtedness for the general puprose of carrying on a brokerage business, which includes the purchase of both taxable and tax-exempt obligations, an allocable portion of interest is disallowed.[5] The revenue procedure does not specify under what circumstances, if any, a bank will be treated as a dealer in tax-exempt obligations. This issue may become more significant as banks expand into businesses previously handled by broker-dealers.

The law as applied to banks

Interest on bank deposits

Legislative history indicates that Congress did not intend the disallowance provision to apply to the indebtedness incurred by a bank to its depositors.[6] The Internal Revenue Service took the position as early as 1924 that indebtedness to depositors was not incurred to purchase or carry tax-exempt obligations, within the meaning of the law. In Rev. Rul. 61-22, 1961-2 C.B. 58, the Service stated its position that the provisions of the law "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be 'indebtedness incurred or continued to purchase or carry obligations * * *' within the meaning of section 265."

The Service has attempted to disallow bank interest deductions in certain cases. Rev. Rul. 67-260, 1967-2 C.B. 132, provided that a deduction will be disallowed when a bank issues certificates of deposit for the specific purpose of acquiring tax-exempt obligations. The ruling concerned a bank which issued certificates of deposit in consideration of, and in exchange for, a State's tax-exempt obligations, the certificates having approximately the same face amount and maturity dates as the State obligations.

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[5] *See Leslie* v. *Comm'r* 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970). The court in *Leslie* held specifically that the exemption of banks under the disallowance provision did not apply to a brokerage business. *See Denman* v. *Slayton*, 282 U.S. 514 (1931).

[6] *See* S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934); S. Rep. No. 830, 88th Cong., 2d Sess. 80 (1964).

In Rev. Proc. 70-20, 1970-2 C.B. 499, the Service issued guidelines for application of the disallowance provision to banks holding tax-exempt State and local obligations. The revenue procedure provides that a deduction will not be disallowed for interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business, unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. The Service will ordinarily infer that a direct connection does not exist in cases involving various forms of short-term indebtedness,[7] including deposits (including interbank deposits and certificates of deposit); short-term Eurodollar deposits and borrowings; Federal funds transactions (and similar interbank borrowing to meet State reserve requirements, and other day-to-day and short-term interbank borrowings); repurchase agreements (not involving tax-exempt securities); and borrowings directly from the Federal Reserve to meet reserve requirements. However, even though indebtedness falls within one of the above categories, unusual facts and circumstances outside of the normal course of business may demonstrate a direct connection between the borrowing and the investment in tax-exempt securities. In these cases, a deduction will be disallowed. The Service will not infer a direct connection merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course of its day-to-day business.

Under Rev. Proc. 70-20, application of the disallowance provision to long-term capital notes is to be resolved in the light of all the facts and circumstances surrounding the issuance of the notes. A deduction will not be disallowed for interest on indebtedness created by the issuance of capital notes for the purpose of increasing capital to a level consistent with generally accepted banking practice. Types of borrowings not specifically dealt with by the revenue procedure are to be decided on a facts and circumstances basis.[8]

Rev. Proc. 78-34, 1978-2 C.B. 535, provided that the Service will allow a deduction for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings are secured by pledges of tax-exempt obligations. The revenue procedure involved transactions in which a depository bank issues interest-bearing notes to the Treasury representing funds withdrawn from the bank's tax and loan account, the notes to be payable upon demand. The Service took the position that this type of borrowing is in the nature of a demand deposit.[9]

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[7] For purposes of the revenue procedure, "short-term bank indebtedness" means indebtedness for a term not to exceed three years. A deposit for a term exceeding three years will be treated as short-term when there is no restriction on withdrawal, other than loss of interest.

[8] Rev. Proc. 72-18, discussed above, is applicable to banks in situations not dealt with in Rev. Proc. 70-20.

[9] Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations. The revenue procedure concerned banks that participate in a State program that requires the banks to bid for State funds and negotiate the rate of interest, and requires the State to leave such deposits for a specified period of time. The Service took the position that direct evidence of a purpose to purchase or carry tax-exempt obligations exists in such transactions under Rev. Proc. 72-18.

Continued

In addition to the foregoing administrative rulings and procedures, two recent court decisions concerned the application of the disallowance provision to financial institutions. In *Investors Diversified Services, Inc.* v. *United States,* 573 F. 2d 843 (Ct. Cl. 1978), the court found that the use of tax-exempt securities as collateral for face-amount certificates[10] was not sufficient evidence of a purpose to purchase or carry tax-exempt obligations. Summarizing the existing law, the court stated that "where the issue is disputed there should always be an inquiry, more-or-less particularized, into the connection and relationship between the tax-exempts and the indebtedness so as to discover whether in fact the taxpayer used borrowed funds for the primary purpose of purchasing or carrying those securities." Noting the many similarities between banks and face-amount certificate companies,[11] the court held that the rationale for the "bank exception" to the disallowance provision was equally applicable to these companies. The court cited three further grounds for holding the disallowance provision inapplicable: (1) that the sale of certificates (*i.e.* borrowing) was wholly separate from and independent of the company's investment process, including the acquisition and maintenance of exempt securities; (2) that the essential nature of the company's business was the borrowing of money which had to be invested in order to pay off the certificate holders; and (3) that the company could not reduce its borrowings by disposing of its tax-exempts, since only the certificate holders had the power to terminate each certificate.

Finally, in *New Mexico Bancorporation* v. *Commissioner,* 74 T.C. 1342 (1980), the Tax Court permitted a bank a deduction for interest paid on repurchase agreements which were secured by tax-exempt State and municipal obligations. The court concluded that the repurchase agreements were similar to other types of bank deposits, and were not the type of loans or indebtedness intended to be covered by the disallowance provision. Furthermore, the bank's purpose for offering repurchase agreements was independent of the holding of tax-exempt obligations.

Recent legislative developments

The Tax Equity and Fiscal Responsibility Act of 1982 added a provision which reduces by 15 percent the amount allowable as a deduction with respect to any financial institution preference item. The Act defined financial institution preference items to include

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Rev. Proc. 80-55 was revoked by Rev. Proc. 81-16, 1981-1 C.B. 688. However, Rev. Proc. 81-16 states that the disallowance provision will continue to apply to interest paid on deposits that are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations.

[10] Face-amount certificates are certificates under which the issuer agrees to pay to the holder, on a stated maturity date, at least the face amount of the certificate, including some increment over the holder's payments. Present law (sec. 265 (2)) provides specifically that interest paid on face-amount certificates by a registered face-amount certificate company shall not be considered as interest incurred or continued to purchase or carry tax-exempt obligations, to the extent that the average amount of tax-exempt obligations held by such institution during the taxable year does not exceed 15 percent of its average total assets. The *Investors Diversified Services* case involved a face-amount certificate company whose tax-exempt holdings exceeded 15 percent of its total assets.

[11] The court noted that both banks and face-amount certificate companies were subject to State banking laws; both competed for the savings of the general public; and both had to invest money obtained from depositors/purchasers to secure payment of an agreed rate of interest to them.

interest on indebtedness incurred or continued by financial institutions[12] to purchase or carry tax-exempt obligations acquired after December 31, 1982, to the extent that a deduction would otherwise be allowable for such interest. Unless the taxpayer (under regulations to be prescribed by the Treasury) establishes otherwise, the 15 percent reduction will apply to an allocable portion of the taxpayer's aggregate interest deduction, to be determined by multiplying the aggregate deduction by the ratio of the taxpayer's average adjusted basis of tax-exempt obligations to the average adjusted basis of the taxpayer's total assets. For example, a bank which has invested 25 percent of its assets in tax-exempts will be denied a deduction for $3,750 of each $100,000 of interest paid to its depositors during the taxable year (15 percent × $25,000 interest allocable to debt used to acquire or hold tax-exempts).

Issues

Overview

The allowance of an interest deduction to banks which acquire or hold tax-exempt obligations raises a number of legal and policy issues. These include (1) administrative problems, including the tracing of borrowed funds and the allocation of funds among different purposes of the taxpayer; (2) a concern for tax equity, since banks are generally allowed to deduct interest on debt used to finance the acquisition or holding of tax-exempt obligations, while most other taxpayers are prohibited from doing so; and (3) the probable effect of any modification of the existing rule on the market for tax-exempt State and municipal bonds.

Administrative problems

The disallowance provision generally

The basic policy of the disallowance provision is to prevent a taxpayer from receiving tax-exempt income and paying tax-deductible interest on the same or equivalent funds. Thus, in a simple case, a taxpayer who borrows $10,000, which he then immediately invests in tax-exempt obligations, is denied a deduction for interest paid to the lender on the $10,000. This prevents a result under which the taxpayer, by receiving the benefits of both tax-exempt income and the interest deduction, would profit (and thereby reduce tax revenues) merely by serving as a pass-through for the funds. Effectively, the law denies the taxpayer the benefits of tax-exempt income to the extent he has financed the acquisition of tax-exempts with the proceeds of indebtedness.[13]

As the taxpayer's finances become more complex, the administration of the disallowance provision becomes progressively more complicated. Because money is essentially fungible—that is, because one $10,000 is the same as any other $10,000—it is difficult to determine whether a taxpayer is financing the acquisition or holding of particular tax-exempt obligations with the proceeds of any particular indebtedness. It may be even more difficult to determine whether the taxpayer has the actual purpose of doing so. This is particularly true in the case of a corporation (or a wealthy individual) which constantly incurs debt for a variety of purposes and which also, in separate transactions, acquires and holds tax-exempts.

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[12] The provision is applicable to mutual savings banks, domestic building and loan associations, and cooperative banks, as well as to commercial banks.

[13] The extent to which the taxpayer actually loses the advantage of tax-exempt income depends upon the prevailing interest rates for taxable and tax-exempt obligations.

Application to banks

The fungibility problem is particularly acute with regard to banks, whose major business consists of the lending and borrowing of interchangeable sums of money, including (to varying degrees) the acquisition and holding of tax-exempt obligations. Even the purposes test, when applied to banks, may result in conflicting conclusions. A bank may argue that, in accepting deposits, it is simply carrying on its general business as a bank[14]—in a sense, that it has an independent business purpose for incurring debt to its depositors. Accordingly, the bank should be allowed an interest deduction under the general principles applicable to all taxpayers. (Alternatively, the bank may argue that the acceptance of deposits does not constitute borrowing, at all.[15]) It may also be argued, however, that one of the major purposes of a bank's general business (as demonstrated by bank practice) is the acquisition and holding of tax-exempt obligations. Thus an allocable portion of deposits accepted in the general course of business should be considered to have been accepted for the purpose of investing in tax-exempts, and the deduction for that portion should be disallowed. This would be equivalent to the treatment accorded under present law to dealers in tax-exempt obligations (other than banks) who borrow money for the purpose of conducting a general brokerage business, including the acquisition and holding of tax-exempts.[16]

Use of a formula for allocation of a bank's deposits between taxable and tax-exempt assets also presents special difficulties. The formulas applied to non-banking taxpayers, which generally rely upon the ratio of tax-exempt obligations to a taxpayer's total assets, may not be adequate to reflect the reality of the banking business. In cases where the interest rate on tax-exempt bonds is less than the interest rate paid by the bank, application of these formulas could result in a loss of deductions in excess of the benefits received from tax-exempt income.

Tax equity

Banks vs. taxpayers generally

Aside from revenue considerations, the strongest argument against present law is that it distinguishes in its application between banks and other taxpayers. By using deposited funds to purchase and carry tax-exempts, banks are able to enjoy the benefits of receiving tax-exempt investment income and paying tax-deductible interest on the same or equivalent funds. This is precisely the double benefit which is denied to other taxpayers. The volume of tax-exempt obligations held by banks indicates that banks have made extensive use of deposited funds to acquire and hold tax-exempts.

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[14] *See Investors Diversified Services, Inc.* v. *United States,* 573 F.2d 843, 852–53. (Ct. Cl. 1978.)

[15] Banks may argue that deposits are distinguished from most other forms of debt, since they are (1) for an unspecified period, and (2) terminable at the will of the depositor, but not of the bank. *See Investors Diversified Services, Inc.* v. *United States,* 573 F.2d 843, 853. (Ct. Cl. 1978.) This argument is obviously less applicable for time deposits.

[16] *See* Rev. Proc. 72-18, 1972-1 C.B. 740; *Leslie* v. Comm'r, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970).

The ability to deduct interest on debt used to purchase tax-exempt securities makes it possible for a bank to eliminate its taxable income by investing a relatively small percentage of its assets in tax-exempt securities. For example, a bank that earns an average return of 8 percent on its taxable assets and pays an average of 8 percent on deposits will pay no tax if it invests 20 percent of its assets in tax-exempt securities.

A particular problem under present law is the use of tax-exempt obligations as collateral for deposits or other short-term bank borrowing. By using tax-exempts as collateral, a bank receives tax benefits when it is really the depositor (who may be tax-exempt or have a low marginal tax rate) who is lending to the issuing government. State and municipal deposits in particular are frequently collateralized with tax-exempt obligations, sometimes of the same State or municipality.[17] In these latter cases, the Federal government subsidizes a transaction in which there is no net borrowing by the State or local government.

Limitations on bank exemption

The history of the disallowance provisions indicates two approaches to limiting the exemption of banks under the disallowance provision. First, the Internal Revenue Service has, on at least two occasions, acted to curb what it perceived as particular abuses of the exemption. Thus, in Rev. Proc. 76–260 *supra,* the Service disallowed a deduction for interest on certificates of deposit which a bank had issued in exchange for tax-exempt State obligations, the certificates having approximately the same face amount and maturity dates as the State obligations. Rev. Proc. 80–55, 1980–2 C.B. 849, would further have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations; however this revenue procedure was subsequently withdrawn.[18]

The difficulty with this approach is that it is necessarily piecemeal, reacting to specific perceived abuses as they occur. Moreover, the approach still applies a different, more favorable standard to banks than to other taxpayers. While taxpayers generally must establish an independent business or personal purpose for incurring debt, banks will be subject to disallowance of interest only when *"unusual facts and circumstances outside of the normal course of business* . . . demonstrate a direct connection between the borrowing and the investment in tax-exempt securities." Rev. Proc. 70–20, 1970–2 C.B. 499, 500 (emphasis supplied). The law thus creates a presumption that debts incurred in the normal course of the banking business are exempt from the disallowance provision. The great majority of a bank's debts will, therefore, qualify for the exemption.

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[17] State and local law generally requires that State and municipal deposits be collaterialized with obligations of specified governmental bodies. These may include taxable or tax-exempt obligations.

[18] The withdrawal of Rev. Proc. 80–55 followed vigorous protests by banks and by various States and municipalities, which argued, *inter alia,* that the revenue procedure would cause serious damage to the market for tax-exempt bonds. This issue is discussed below.

Congress took a second approach in 1982 when it characterized the deductibility of interest on debt used to acquire or hold tax-exempt obligations as a financial institution preference item, and reduced the otherwise allowable deduction for this type of interest by 15 percent. This reduction was accompanied by equivalent cutbacks in various other items characterized as corporate tax preferences.[19] By its own terms, however, the 1982 Act reduced, rather than eliminated, the benefits enjoyed by banks with regard to the interest deduction. To the extent that banks are treated differently than other taxpayers, they continue to be treated differently with respect to 85 percent of the interest at issue. The flat reduction approach also raises potential problems of enforcement and allocation,[20] particularly with regard to affiliated and consolidated corporations. Finally, a flat reduction does not take into account the particular situations of various banks, or their reason for acquiring or holding tax-exempts.

Each of the approaches above suggests possible further changes in the application to banks of the disallowance provision. Congress could act, or direct the Internal Revenue Service to act, to curb perceived areas of abuse by financial institutions and issuing jurisdictions, including (but not limited to) certain kinds of deposits collaterized with tax-exempt obligations. Congress could also impose further numerical or percentage limits on the overall amount of the deductions at issue. Each of these approaches would involve the problems suggested by the discussion above. Alternatively, Congress could act to eliminate the entire deduction for interest paid by banks on debt used to acquire or hold tax-exempts.

State and municipal finance

Tax-exempt bonds are a major source of financing for State and municipal governments. In effect, denying the interest deduction in proportion to a taxpayer's holdings of tax-exempt obligations involves taxing a fraction of the otherwise tax-exempt interest (under some formulas, more than 100 percent of the interest). This reduces the attractiveness of the bonds to potential holders. Legislative history indicates a Congressional concern that, if banks were denied an interest deduction in proportion to their tax-exempt holdings, the banks would eliminate or substantially reduce their investments in tax-exempt bonds. The Senate Finance Committee in 1934, rejecting a proposed change in the rule, expressed the opinion "that the change made by the House bill will seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions, and also presents grave administrative difficulties." [21]

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[19] The law also characterized excess bad debt reserves as a financial institution preference item.

[20] The law provides (unless the taxpayer establishes otherwise) for disallowance of 15 per cent of that portion of deductible interest which is equivalent to the proportion of tax-exempt obligations acquired after 1982 in the taxpayer's total assets. This is essentially the same formula used to allocate interest for taxpayers generally (with the exception that 100 percent of allocated interest in the case of a general taxpayer will be disallowed). Because the law is effective only for taxable years beginning on or after January 1, 1983, there is as yet no available data regarding compliance or enforcement.

In 1980, when the Internal Revenue Service issued Rev. Proc. 80-55 *supra*, banks, and various State and local governments, protested that the disallowance of deductions on the deposits in question would depress the market for tax-exempt bonds, making it more difficult for States and municipalities to raise needed funds. Additionally, they argued that banks would refuse to accept State and municipal deposits, which generally must be secured by specified taxable or tax-exempt obligations. (It was also argued that the revenue procedure was inconsistent with previous interpretations of the disallowance provision.)

The Service revoked Rev. Proc. 80–55 in April 1981. In a statement accompanying the revocation, the Treasury and the IRS concluded that the overall effect of the revenue procedure on the municipal bond market, the banking system and the fiscal health of State and local governments would have been slight.[22] This referred, however, only to the effect of the revenue procedure itself, rather than to the presumably broader effect of disallowing interest deductions on all deposits in proportion to a bank's tax-exempt holdings.

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[21] S. Rep. No 558, 73d Cong., 2d Sess. 24 (1934).

[22] Revenue Procedure 80–55: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 97th Cong., 1st Sess. 4 (1981) (statement of John E. Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury, and Roscoe L. Egger, Jr., Commissioner of Internal Revenue).

C. Foreign Income

Present Law

Foreign tax credit

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States allows U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country ("foreign tax credit").

In addition, a U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that foreign corporation on earnings that are distributed as dividends.

A credit is available only for foreign taxes that are income taxes under U.S. concepts (sec. 901) and certain taxes paid to a foreign government in lieu of an income tax otherwise imposed by that foreign government (sec. 903). A foreign tax is an income tax if it is designed to reach realized net income. Certain taxes imposed on gross payments of interest and other passive type income are creditable. However, gross withholding taxes imposed on gross recipts of U.S. taxpayers engaged in trade or business in a foreign country have been held not creditable (Rev. Rul. 78-233, 1978-1 C.B. 236).

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the Code contains a limitation to ensure that the credit offsets the U.S. tax on only the taxpayer's foreign income. The limitation is determined by using a ratio of foreign source taxable income to total worldwide taxable income.[1] The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes that, absent a foreign tax credit, would be paid on the foreign income and, thus, the upper limit on the foreign tax credit. Deductions apportioned to foreign source gross income reduce the foreign tax credit limitation, while deductions apportioned to U.S. source income do not.

The United States has entered into a number of bilateral income tax treaties that reduce or eliminate source country flat-rate withholding taxes on passive income, including interest. The U.S. position is that the rate on interest should be zero. A number of treaties have a zero rate only for interest paid to banks.

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[1] Historically, the foreign tax credit limitation has been based upon either the taxpayer's worldwide foreign income or his foreign income from each separate country, or both. These are known as the overall limitation and the per-country limitation, respectively. Under the per-country limitation, taxes paid to any foreign country could be used against only the pre-credit U.S. tax on income from sources within that country. Today, some foreign countries use a per-country limitation, while others use a separate limitation for every item of income.

U.S. taxation of foreign corporations and their U.S. shareholders

Foreign corporations generally are taxed by the United States only on their U.S. source income and on foreign source income that is effectively connected with a trade or business conducted in the United States. Accordingly, the foreign source income of a foreign corporation is subject to U.S. income tax only when it is actually remitted to the U.S. shareholders as a dividend. However, under the subpart F provisions of the Code,[2] income from certain tax haven type activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them (subject to a foreign tax credit). The categories of income taxed include foreign personal holding company income which in turn includes interest income. Also, earnings of controlled foreign corporations are generally taxed currently to U.S. shareholders if they are invested in certain U.S. property.

Rules of particular significance for U.S. banks

In general, banks are subject to the same tax rules on their income from international transactions as other U.S. taxpayers. Some of these rules are of particular significance to banks and are described below.

Source of income

Foreign source taxable income increases a taxpayer's foreign tax credit limitation. Foreign source income may thus increase the amount of foreign taxes a taxpayer may credit and decrease the taxpayer's U.S. tax liability. For this reason, taxpayers may prefer foreign source income to U.S. source income.

Interest income has its source in a country when the obligor is a governmental entity, a corporation, or another entity resident in that country. Thus, interest on a loan to a foreign entity is foreign income regardless of where the loan proceeds are used.[3] However, a proportionate amount of the interest paid by a foreign corporation is treated as U.S. source if 50 percent or more of that corporation's gross income is effectively connected with a U.S. trade or business, while all interest paid by a U.S. corporation is foreign source if the corporation has over 80 percent of its gross income from foreign sources over the past three years.

Under these rules, if a bank lends to a foreign corporation (such as a foreign bank) that invests in the United States, or to a foreign subsidiary of a U.S. corporation that invests abroad, the bank will generally earn foreign source interest income.

As a general rule, the source of income from leasing a vessel or aircraft is where the vessel or aircraft is used. Thus, most of the income from vessels or aircraft used in international commerce would be foreign source, and related deductions would be allocable or apportionable to foreign sources and would reduce the available foreign tax credit limitation. However, in 1971, Congress enacted a special elective rule allowing U.S. lessors to treat income and deductions from leases of certain ships and aircraft as U.S. source. In adding this elective rule, Congress took notice that "One of the principal means available to finance the purchase of ships or aircraft is a leasing arrangement under which a financial institution purchases the ship or aircraft and then leases it to the air carrier or ship operator . . . ." S. Rep. No. 92-437, 92d Cong., 1st Sess. 78. "Typically, in a leasing transaction of this type, the lease produces a tax loss during its early years to the lessor (primarily as a result of the depreciation deduction)." *Id.* Congress created the election to treat these losses as reducing U.S. income because "The characterization of the loss as foreign source in combination with the limitation on the foreign tax credit can have the effect of causing the financial institution to lose a foreign tax credit to which it would otherwise be entitled for foreign taxes paid with respect to its foreign banking or other financial operations." *Id.* Although the primary intent of this elective rule was to provide air carriers and ship operators with the financing needed to acquire new equipment, this rule incidentally benefitted banks.

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[2] Similar rules would apply to tax U.S. shareholders of foreign personal holding companies.

[3] Banks may be able to source other income in foreign countries by locating operations or transferring title there. Only the easy transferrability of money may distinguish banks from other taxpayers in this respect.

In 1980, Congress made this elective rule mandatory (Public Law 96-605, Code sec. 861(e)).

The source of income from foreign currency trading is generally the country where title to the currency passes to the buyer. This rule may allow banks to generate foreign source income from profitable investments and U.S. losses from unprofitable investments.

Apportionment of interest expense

The apportionment of deductions between U.S. and foreign source gross income has a significant impact on the foreign tax credit limitation. Because banks, by the nature of their business, borrow large sums of money, the rules governing apportionment of interest expenses to U.S. and foreign sources are of particular importance to banks.

Method.—The Treasury Regulations governing allocation and apportionment of interest expense are generally based on the approach that money is fungible and that interest expense is attributable to all activities and property of the payor regardless of any specific purpose for incurring an obligation on which interest in paid (Treas. Reg. sec. 1.861-8(e)(2)(i)). The regulations do not provide for tracing of interest expense on borrowed funds to the investments made with those funds. To the extent that banks obtain funds for loans to U.S. borrowers more cheaply than they obtain funds for loans to foreign borrowers, the Regulations provide more foreign source taxable income than a tracing approach and tend to increase the banks' foreign tax credit limitation. This may reduce the banks' U.S. tax liability on foreign source income.

In general, taxpayers may allocate interest deductions to specific property only in the case of certain nonrecourse debt (Treas. Reg. sec. 1.861-8(e)(iv)). Taxpayers may elect, on an annual basis, to apportion interest deductions that are not allocable to specific property by either of two methods, the asset method or the gross income method.[4] Under the asset method a taxpayer may apportion its interest deductions between foreign and domestic sources by comparing assets generating foreign gross income to assets generation all gross income. The debt obligation of a foreign entity will ordinarily be a foreign asset. Under the gross income method, expenses are apportioned to offset foreign source income by comparing foreign source gross income to worldwide gross income.

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[4] Foreign corporations engaged in trade or business in the United States are subject to a different set of rules, discussed below, for determining interest deductions for U.S. tax purposes.

Interest paid to carry tax-exempt bonds.—As described above, a bank may invest deposited funds in tax exempt obligations while continuing to deduct the full amount of interest it pays to depositors. However, the tax exempt obligations are domestic assets for purposes of applying the asset method of allocating interest deductions between United States and Foreign sources.

Elections.—Under the asset method the taxpayer has additional flexibility to apportion interest deductions. The taxpayer may generally choose to value assets on the basis of book value or on the basis of fair market value. In addition, taxpayers using the asset method may apportion interest on certain debt incurred before January 1, 1977 by certain other methods.

Separate limitation for interest income

The foreign tax credit limitation is computed separately for certain interest income (sec. 904(d)). Interest "derived in the conduct by the taxpayer of a banking, financing, or similar business . . ." is excluded from that separate limitation. (Code sec. 904(d)(2)(B)).

The absence of a separate limitation for interest derived in the banking business could allow credits for foreign taxes on other foreign income, such as foreign fee income, to reduce U.S. tax on interest income. Likewise, foreign income taxes imposed on interest income can reduce U.S. tax on other classes of foreign income.

Foreign subsidiaries of U.S. banks

Interest income (as well as dividends and certain gains on the sale of stock or securities) of a foreign banking subsidiary of a U.S. bank is exempt from subpart F, and thus, is not taxed to the U.S. shareholder if it is derived in the conduct of a banking or other financial business and is received from an unrelated party (Code sec. 954(c)(3)(B)).[5] The securities producing that income must be "acquired as an ordinary and necessary incident" to the conduct of a banking business (Treas. Reg. sec 1.954-2(d)(2)(iii). For this purpose, "securities" include any debt obligation or right to purchase any debt obligation. In general, however, certain second-tier subsidiaries of national or State banks which are members of the Federal Reserve System need not meet the "incidental" test (Treas. Reg. sec. 1.954-2(d)(2)(iv)).

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[5] The Internal Revenue Code contains two sets of rules aimed at preventing the use of corporations to avoid taxation on passive income at the level of the ultimate investor, the shareholder. Neither set of rules generally applies to foreign subsidiaries of U.S. banks engaged in a banking business. One such set of rules, the personal holding company rules, does not apply to U.S. banks or, in general, to foreign corporations that derive 60 percent or more of their ordinary gross income "directly from the active and regular conduct of a lending or finance business" (sec. 542(c)). The other set of rules, the foreign personal holding company rules, does not generally apply to "a corporation organized and doing business under the banking and credit laws of a foreign country if it is established . . . to the satifaction of the Secretary that such corporation is not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed upon its shareholders" (sec. 552(b)(2)).

There is another special rule in the subpart F provisions for banks. Although most U.S. shareholders are subject to some current taxation if income from certain transactions with related parties amounts to 10 percent of the gross income of a controlled foreign corporation, subsidiaries of U.S. banks may generally receive up to 30 percent of their gross income from related parties in the banking business without subjecting the U.S. parent to current taxation under subpart F (Code sec. 954(c)(4)(B), Treas. Reg. sec. 1.954-2(e)(2)).

Interest deductions of foreign banks

Under Treasury Regulations, for purposes of computing their U.S. taxable income, foreign corporations are subject to rules for allocation of interest deductions that are different from the "fungibility" rules governing U.S. corporations. Foreign corporations engaged in U.S. trade or business may elect a "branch book/dollar pool" method, which considers primarily the interest the branch paid and secondarily dollar borrowings of the foreign corporation, or a "separate currency pools" method, which considers the interest the corporation paid on a currency-by-currency basis (Treas. Reg. sec. 1.882-5). Under these rules, low-cost home country deposits need not reduce U.S. interest deductions. In addition, borrowings in a strong currency that bear a low nominal rate of interest to compensate for expected appreciation in value of principal need not reduce U.S. interest deductions.

Miscellaneous rules

A number of tax rules governing the customers of banks incidentally provide special treatment for banks.

Tax law encourages foreign persons to make deposits in U.S. banks. Foreign persons are generally not subject to U.S. income taxation on deposits in U.S. banks unless the income from those deposits is effectively connected with a trade or business in the United States. Nonresident aliens are generally not subject to estate or gift taxation on gratuitous transfers of such deposits. Banks have only a minor burden in policing the identity of persons who claim foreign status. There is no requirement that payors of interest to persons claiming foreign status report such payments to the Internal Revenue Service.

Persons collecting foreign items (such as interest or dividends paid by foreign corporations) for U.S. persons need not report the collection of such foreign items unless they amount to $600 or more (Treas. Reg. sec. 1.6014-4).

In general, under the subpart F provisions of the Code, a foreign corporation controlled by U.S. shareholders subjects those shareholders to current U.S. tax when it invests its retained earnings in United States property, such as stock or debt of domestic issuers. A special statutory provision exempts from this rule "deposits with persons carrying on the banking business" (Code sec. 956(2)(A)).

Issues

Measure of foreign source income

The present method of computing foreign source income for purposes of the foreign tax credit limitation may result in higher foreign source income than would seem correct. If so, too much foreign tax could be credited. Additional foreign tax credits could reduce U.S. tax and might permit banks to reduce U.S. tax on what should be considered U.S. source income. On the other hand, the present method may result in a correct computation of foreign source income. The key elements in this calculation are the source of income rules and the alloction of deduction rules.

Source of income

Proponents of the current rule that the source of interest income is the residence of the payor argue that this rule allows U.S. taxpayers to treat as foreign source income the income that foreign governments are likely to tax. This result, they argue, is consistent with the policy of the credit to mitigate double taxation.

Opponents of the current rule argue that it gives taxpayers the flexibility to lend to a foreign member of a related group and thus to increase the foreign tax credit limitation. They point out that lenders may thus generate foreign source income that will be subject to no foreign tax.

Proponents of the current rules treating leasing of U.S. ships and aircraft as yielding U.S. source income and deductions argue that this treatment is appropriate because foreign countries are unlikely to tax such leasing income. Therefore, categorization as foreign source is unnecessary. Opponents of this rule argue that the special rule tends artificially to reduce U.S. source income and to benefit lessors, and that the general rule reducing foreign source income would be as appropriate in this context as elsewhere.

Proponents of the current rule that the source of foreign currency trading income is the country where title passes note that this rule is a generally accepted source rule. They argue that any other rule would be unworkable or arbitrary.

Opponents of the title passage rule argue that it allows banks selling currency to increase foreign source income and to decrease U.S. source income.

Allocation rules

Proponents of current law allocation of interest expenses argue that money is fungible and that interest expense is attributable to all the activities and property of a business regardless of any specific purpose for incurring an obligation on which interest is paid. Fungibility, they say, recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. They contend that when money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and that it is reasonable to attribute the cost of borrowing to such other purposes.

Opponents of the current fungibility rule argue that tracing would result in a more accurate calculation of foreign source income. They argue that fungibility artificially increases the foreign tax credit limitation and thus may reduce U.S. taxes. For example, assume that a bank (1) borrows $1,000 from a U.S. depositor at 5 percent and invests that $1,000 in a loan to a U.S. borrower yielding 9 percent, and (2) borrows $9,000 from a foreign depositor at 10 percent and invests that $9,000 in a loan to a foreign borrower yielding 11 percent. A tracing method would treat $40 as U.S. source income and $90 as foreign source income. The asset method apportions the total $950 of interest paid on the basis of assets. U.S. assets ($1,000) are 10 percent of total assets, so $95 (10 percent of interest expense) is deducted from U.S. source income. This results in a U.S. loss of $5 ($90 interest received less $95). Foreign source income is $135 ($990 of interest received less $855 (90 percent x $950)). Opponents of fungibility say that both these loans are profitable. They also note that foreign banks doing business in the United States are not subject to the fungibility rules. They argue that when interest rates in this country vary from interest rates abroad, these different interest rates reflect different costs of banking in this country and abroad. They note that foreign banks (1) factor in interest rate differentials and (2) disregard any low-cost home country deposits in calculating U.S. income. If fungibility is inappropriate for these banks, opponents argue, it is also inappropriate for U.S. banks.

Proponents, however, argue that tracing of interest expense to specific assets would cause administrative difficulties. They also argue that tracing could cause compensatory taxpayer behavior, such as seeking to match low-cost funds with foreign assets. Such behavior could include requirements that U.S. borrowers (or related parties) establish low-interest-rate deposits overseas.

Opponents of current law argue that even if fungibility is the correct approach, there should be one method of calculating interest deductions under that approach to yield the correct result. Thus, they say, there should be no elections among asset method, book or fair market value, and gross income method.

Proponents of the current elections argue that these elections are necessary to measure properly income of differently situated businesses, some of which have high foreign assets in relation to foreign gross income, and some of which have low foreign assets in relation to foreign gross income.

Interest paid to carry tax-exempt bonds

Proponents of the current rule treating tax-exempt obligations like any other U.S. asset for the purpose of apportioning interest expense argue that this rule reflects the true economic nature of the transactions because interest paid to carry tax-exempt bonds relates to U.S. assets. They also argue that this rule is consistent with the policy of permitting the deduction of the interest which is to encourage banks to hold tax-exempt State and municipal obligations. Removing these obligations from the allocation would be inconsistent with this policy.

Opponents of the current rule argue that if banks should not trace interest deductions to tax-exempt interest income in determining the *amount* of income, banks should not trace interest deductions to tax-exempt income in determining the *source* of income. They argue that it is inappropriate to derive a second tax benefit

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(higher foreign source income) from ownership of a tax-exempt asset.

Gross withholding taxes

Proponents of the creditability of gross withholding taxes on passive income argue that such taxes are income taxes. They note that such taxes are a standard international device, that the United States has such taxes, that the United States labels its taxes income taxes and that other countries credit these U.S. taxes. Even if these taxes are not income taxes, proponents of the current rule argue that such taxes are comparable to income taxes and are thus creditable as taxes in lieu of income taxes. They note that the rates of such taxes are not unlike marginal income tax rates in the United States. They note that a taxpayer who invests his own capital is subject to net income tax rates beyond the 25–30 percent range in the United States and in many other countries.

Opponents of creditability argue that a gross withholding tax on persons in the active business of lending money is neither an income tax nor comparable to a net income tax. They note that lending margins of bankers rarely attain the rates of gross withholding taxes, which can reach 15 or 25 percent of gross interest. They argue that if the lender is bearing the tax, the tax is not designed to reach net income but rather to exceed net income and is thus not creditable. They say that if the borrower, not the lender, is bearing most or all of these taxes, then they should not be creditable against the lender's U.S. taxes. They argue that current law may allow foreign tax credits for high taxes to eliminate the U.S. tax on other, low-taxed, foreign source income. Opponents argue that these credits, if allowable at all, should not apply against taxes on other foreign source income.

Proponents of creditability argue that it may be in the interest of the United States to credit certain taxes, even though they may be relatively high, imposed by friendly countries. Creditability may encourage private investment in these friendly countries and may indirectly help create markets for U.S. goods and jobs for U.S. workers.

Some argue that even if gross withholding taxes generally should be creditable, such taxes imposed by a foreign government on a loan to a government-owned corporation or a quasi-governmental entity should not be creditable or should be separately limited. They argue that such taxes constitute a rebate of interest charges.

Proponents of creditability argue that the identity of the borrower should not affect the creditability of taxes. They note that the United States taxes the interest income it pays.

Those concerned about the creditability of gross withholding taxes also object to the absence of a separate foreign tax credit limitation for banks' interest income. They argue that current law allows only banks to offset U.S. tax on low-taxed foreign source fee income or trading income with credits from high-taxed foreign source interest income (or vice versa).

Proponents of the current rule exempting banks from the separate limitation for interest income argue that interest in the hands of banks is active business income, and should not be treated differently from other business active income.

Deferral

Proponents of the deferral of U.S. taxation on the earnings of controlled foreign banking subsidiaries argue that interest income, although passive in the hands of an investor, is active income in the hands of a financial intermediary.

Apparently, the reported return on assets on U.S. banks' foreign subsidiaries is higher than that of both the total international operations of large U.S. banks and the banks' consolidated (worldwide) operations. Board of Governors of the Federal Reserve System Staff Study, Foreign Subsidiaries of U.S. Banking Organizations 6 (1982).

Opponents of deferral argue that these high reported returns may indicate that banks can choose to do highly profitable business offshore. They argue that interest income is passive income even in the hands of a financial intermediary. They argue that it is easy to choose to earn interest income or currency trading income in a controlled subsidiary and thus to defer U.S. tax.

Proponents of deferral argue that reported return on assets does not necessarily reflect economic profits. They note that ending deferral would create administrative problems.

Some may argue that even if deferral is proper as a general rule for foreign subsidiaries of U.S. banks, the current rule allowing receipt of up to 30 percent of gross income from related parties without incurring subpart F income is too lenient. Such a rule, they may argue, allows transfer pricing issues to develop, and is not in line with the 10 percent test generally applied to corporations other than banks.

Advocates of the current 30 percent test argue that it is not comparable to the 10 percent test applied to corporations other than banks. They also argue that transfer pricing problems are less prevalent in the lending of money than in the sale of goods, because comparable prices are easier to find for lending businesses. They also argue that intra-group transactions are more proper among banks than among other related parties.

Miscellaneous rules

Proponents of the current rules encouraging deposits in U.S. banks argue that these rules help capital formation in the United States.

Opponents of these rules argue that they do not necessarily encourage retention of capital in the United States because banks are free to lend these funds to foreign persons. They argue that banks should in any event bear more responsibility to insure depositors' compliance with U.S. tax laws.

D. Tax Exemption for Credit Unions

Present Law

Under present law, credit unions are exempt from Federal income tax regardless of whether their income is distributed as dividends.

Legislative History

State chartered credit unions have always been exempt from Federal income tax. Until 1951, the tax exemption for State-Chartered credit unions was subsumed under the tax exemption for savings and loan associations. When the exemption for savings and loan associations was terminated as part of the Revenue Act of 1951, the exemption for credit unions was continued in a separate Code provision. Federal credit unions have been exempt since enactment of the Federal Credit Union Act of 1934, which established federally chartered credit unions.

Issues

Originally, credit unions were exempted from tax along with savings and loan associations because both credit unions and savings and loan associations operated on a "mutual" basis (that is, on behalf of and for the benefit of their members), and not as separate profit-seeking entities. In addition, credit unions were generally small, unsophisticated financial institutions, operated by volunteers.

However, today there are many large credit unions, and credit unions offer depositors an array of services that are not always distinguishable from those offered by banks and savings and loan associations. Other types of mutual financial institutions, which compete with credit unions, are subject to tax on income not paid out to member-depositors as dividends. Furthermore, some credit unions appear to manage their asset portfolios so as to tap national capital markets. Some argue, therefore, that the credit union exemption should be reconsidered and credit unions be treated no differently than other thrift institutions.

Credit union representatives argue that they are unlike mutual savings and loan associations and mutual savings banks because they tend to be more closely controlled by their depositors, rather than by a board of directors. The law requires that a majority of the directors of a credit union receive no compensation and forbids proxy voting in credit union elections. These requirements, it is argued, ensure that credit unions, unlike other mutual institutions, will not operate like profit-seeking entities.

E. Deductibility of Dividends by Mutual Thrift Institutions

Present Law

Prior to 1952, mutual savings banks, cooperative banks, domestic building and loan associations and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law were not subject to income tax. Since then, and under present law, these thrift institutions have become subject to the generally applicable provisions of the Code as well as some special tax rules.

In determining their taxable income, thrift institutions are allowed a special deduction from gross income for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts. Because these amounts are in the nature of interest, this deduction is allowed regardless of whether the amounts are denominated as dividends or interest. However, these amounts paid or credited must be withdrawable on demand, subject only to the customary notice of intention to withdraw. Thus, amounts paid as a dividend on the non-withdrawable capital stock accounts of a domestic building and loan association or a mutual savings bank are not deductible. Such a nondeductible dividend is a distribution out of earnings and profits as it is in the case of any other corporation.

The deduction for amounts credited as dividends or interest by thrift institutions is allowed in the taxable year in which such amounts become withdrawable by the depositor or accountholder. Thus, regardless of the accounting method used by the thrift institution, this deduction is not allowable on an accrual basis. The use of the "withdrawable" standard generally makes the deduction allowable when a cash-basis depositor or accountholder would include the amount in income, a question which may depend on the application of the constructive receipt principles and the provisions for recognizing accrual of original issue discount. Finally, the deduction is not denied because amounts that are credited, and otherwise deductible, are subject to the terms of a pledge agreement between the depositor or accountholder and the thrift institution.

Issues

Because a mutual thrift institution is theoretically operated for the benefit of its depositors or accountholders, conceptually such depositors or accountholders are not creditors in the same sense depositors of a commercial bank are considered to be. At the same time, however, the amounts credited to these accounts are in the nature of interest; they are derived from activities and are credited in a manner comparable to those used by commercial banks obligated to pay interest on funds on deposit. Thus, a member-depositor of a thrift institution might be considered to have a dual character, that of both an owner and a creditor. One suggestion is that shareholder-depositors be treated as owners to the extent that their dividends represent a reasonable rate of return on the equity capital of the institution. Thus, a percentage of dividends approximating this amount could be made nondeductible.

The present dividend deduction might be considered to follow a conduit theory as its model for taxing the income of a thrift institution. The thrift institution receives income on behalf of its depositor members; to the extent such income is distributed, because it is withdrawable on demand, only the depositors are taxed. However, by allowing a full deduction for amounts credited to withdrawable funds, the present provisions might be seen as failing to recognize the dual character of the depositor-members.

A similar situation, but a different tax approach, exists under present law for the treatment of policyholder dividends paid by mutual life insurance companies. Like thrift institutions, mutual life insurance companies are organized and operated for the benefit of their member-policyholders. However, under present law, a mutual life insurance company generally cannot deduct the full amount of the dividends it pays or credits to policyholders. For example, limitations temporarily in effect under the Tax Equity and Fiscal Responsibility Act of 1982 allow a mutual life insurance company to deduct 77½ percent of policyholder dividends paid during the year, whereas a stock life insurance company is allowed to deduct 85 percent. The 7½ percent difference for comparable deduction items has been referred to as the "profit differential" or "ownership differential" between mutual and stock companies engaged in the same business. Such a differential might be said to recognize, to some extent, the dual character of a policyholder in a mutual ife insurance company, that of both an owner and a policyholder. However, unlike an owner/depositor in a mutual thrift institution, an owner/policyholder in a mutual insurance company generally is not taxed on policyholder dividends credited to him.

Casualty insurance companies and mutual funds, however, are presently allowed a deduction for 100 percent of policyholder dividends.

Thrift institutions argue that most of their accounts are viewed by the depositors as deposits, not as equity interests in the institutions, and involve obligations virtually identical to those of a strict debtor-creditor relationship. Denying a deduction for part of the dividends paid by mutual institutions, therefore, would be unfair and could lead to income tax being paid by thrift institutions which, by ordinary standards, are in financial difficulty. Furthermore, a deduction denial would not necessarily raise very much revenue, since most accounts would be converted into interest-paying, not dividend-paying, status and would qualify for the ordinary interest deduction.

F. Miscellaneous Issues

1. Exemption From Straddle Provisions

Present Law

The Economic Recovery Tax Act of 1981 (ERTA) adopted a number of rules governing the tax treatment of straddles. Straddles consist of offsetting positions in actively traded personal property, other than stock. The measures adopted by ERTA were designed to prevent deferral of income, and in some cases the conversion of ordinary income or short-term capital gain into long-term capital gain, by closing positions on which a loss was sustained or by incurring deductible costs while delaying the closing of offsetting postions reflecting unrealized gain until a later year.

With respect to straddle transactions, these measures preclude the current deduction of certain interest charges and carrying costs, require the deferral of losses to the extent of unrealized gain on offsetting positions, and authorize regulations to apply rules comparable to the statutory wash sale and short sale rules to straddle transactions. In addition, all regulated futures contracts held by a taxpayer at the close of the taxable year are subject to tax as if they were then sold at their fair market value. This treatment follows the marking to market rules employed by the domestic futures exchanges. The mark to market rules were extended by the Technical Corrections Act of 1982 to cover certain contracts for the delivery of foreign currency that are traded in the interbank market.

Hedging transaction are excluded from the straddle rules, including the mark to market treatment of futures contracts and foreign currency contracts traded in the interbank market. A hedging transaction is one with respect to which both the hedge and the property hedged produce only ordinary income or loss and which is entered into in the normal course of the taxpayer's trade or business. In addition, if the taxpayer is not a bank (as defined in sec. 581), a transaction qualifies for the hedging exception only if it is entered into primarily (i) to reduce risk of price change or currency fluctuation with respect to taxpayer-held property, such as inventory, or (ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings or obligations of the taxpayer.

Issues

The exemption of banks from these primary purpose requirements was intended to allow certain business activities which are regularly conducted by banks, but which may not be conducted primarily for risk reduction (for example, foreign currency trading), to be exempt from the straddle rules. It was argued that the straddle rules would be burdensome to banks and that banks do not typically engage in the transactions which would otherwise be subject to those rules for tax-avoidance purposes; therefore the banks should be exempt. However, other taxpayers who engage in non-tax-motivated business transactions may not qualify for the hedging exception and have requested that the special rule for banks be extended to them (e.g. market-makers in options).

2. Credit Card Start-up Costs

Present Law

Deductibility of start-up costs.—Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not currently deductible since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

Expenses or costs incurred in acquiring or creating an asset, e.g., a business, which has a useful life that extends beyond the taxable year normally must be capitalized. These costs ordinarily may be recovered through depreciation or amortization deductions over the useful life of the asset. However, costs which relate to an asset with either an unlimited or indeterminate useful life may be recovered only upon a disposition or cessation of the business.

5-year amortization of start-up costs.—In 1980, a provision (sec. 195) was enacted which allows business start-up cost expenditures to be amortized, at the election of the taxpayer, over a period of not less than 60 months beginning with the month the business begins. In general, expenditures eligible for this amortization must satisfy two requirements. First, the expenditure must be paid or incurred in connection with creating, or investigating the creation or acquisition of, an active trade or business entered into by the taxpayer. Second, the expenditure must be one which would be allowable as a deduction for the taxable year in which it is paid or incurred if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.

Credit card costs.—Several courts have held that start-up fees incurred by banks to participate in a credit card system are deductible business expenses.[1] These expenses include such items as promotional and advertising costs, credit reports, operating manuals, and program costs.

Issues

The issue is whether start-up fees incurred by banks in starting in the credit card business should be treated as non-deductible start-up costs eligible for 5-year amortization.

On the one hand, it can be argued that the expansion by a bank into the credit card business should be viewed as the entry into a new business and the costs incurred should be required to be amortized since the business will generate income over a period of years. On the other hand, the entry into the credit card field may be viewed as an expansion of the existing lending business and the otherwise deductible start-up costs should be treated the same as those in other expanding businesses.

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[1] *Colorado Springs National Bank* v. *U.S.*, 505 F.2d 1185 (10th Cir. 1974); *First Security Bank of Idaho* v. *U.S.*, 592 F.2d 1050 (9th Cir. 1979), *aff'g* 63 T.C. 644 (1975); *Iowa-Des Moines National Bank* v. *Commr.*, 592 F.2d 433 (8th Cir. 1979), *aff'g* 68 T.C. 872 (1977).

3. Special Rules Involving Reorganizations of Financially Troubled Thrift Institutions

Present Law

In 1981,[1] Congress enacted several relief provisions designed to aid the then-ailing thrift industry. These provisions facilitate tax-free reorganizations of troubled thrifts, relax loss carryover rules, exclude from income recapture amounts when thrifts make certain distributions to the FSLIC, and liberalize the rule applicable when the FSLIC contributes to the capital of certain thrift institutions.

Tax-free reorganizations

Present law contains special rules designed to facilitate reorganizations of financially troubled thrift institutions undertaken under the jurisdiction of the Federal Home Loan Bank Board (FHLBB) or Federal Savings and Loan Insurance Corporation (FSLIC) (or, if neither has supervisory authority, an equivalent State authority). Institutions to which this rule applies are savings and loan associations, cooperative banks, and mutual savings banks (i.e., thrift institutions to which sec. 593 applies). The continuity of interest doctrine (which requires that shareholders of the acquired corporation must continue to have an interest, through stock ownership, in the successor corporation) does not apply to such reorganization transactions. With respect to such thrift institution reorganizations, there is no requirement that stock or securities in the transferee corporation must be received or distributed in the transaction. Substantially all the assets of the transferor, however, must be acquired by the transferee and substantially all the liabilities of the transferor, including deposits, immediately before the transfer must become liabilities of the transferee.

Loss carryovers

In general, if one corporation acquires another in a reorganization and the other corporation has a net operating loss, and certain other requirements are met, the net operating loss of the loss corporation must be reduced (section 382(b)). However, in applying this rule to the reorganization of thrift institutions which has been certified by FHLBB or FSLIC deposits in the acquired corporation which become deposits in the transferee corporation are treated as stock of both corporations. Thus, the loss limitation rule has reduced application in the case of the reorganization of a savings and loan association.

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[1] The Economic Recovery Tax Act of 1981, sections 241-244 and 246, effective for taxable years after 1980.

Distributions out of bad debt reserves

In general, when a savings and loan association makes a distribution to its shareholders out of excess bad debt reserves (i.e., in general, the excess of the reserve for losses on qualifying real property loans over the reserve which would have been allowable under the experience method), it must report that amount as ordinary income (section 593(e)). This recapture rule does not apply, however, to distributions to the FSLIC in redemption of an interest in a thrift institution received in exchange for financial assistance.

FSLIC contributions to savings and loan associations

Contributions to capital by nonshareholders are excluded from the income of the recipient corporation (sec. 118), but the basis of property is reduced by such contributions (sec. 362(c)). However, a savings and loan association need not reduce basis for money or property contributed to it by the FSLIC under its financial assistance program.

Issues

These provisions were designed to assist FHLBB and FSLIC in reorganizing financially troubled thrift institutions at a time when there was concern over the survivability of many thrift institutions. In effect, they reduce the direct outlay cost to FSLIC of subsidizing reorganizations by substituting more favorable tax treatment for direct outlays. In 1981, this may have been justified by the extremely serious problems which might have been created had it been necessary to enact additional appropriations for FSLIC in the event that depositors become concerned over the solvency of FSLIC and withdrew deposits from some institutions.

However, the question arises how long these provisions will be needed now that interest rates have fallen and the health of the thrift industry has improved. The banking industry has suggested that it be made eligible for similar treatment. Congress may, therefore, want to consider some sunset date for these provisions before they become a precedent for other industries.

Some would argue that the reorganization provision (with respect to the continuity of interest doctrine) clarifies the treatment of thrift reorganizations and should be retained, even if other ERTA amendments benefiting the thrift industry are limited or repealed.

4. Foreclosure on Property Securing Loans

Present Law

In general, foreclosure by a creditor on property in which the creditor holds a security interest is a taxable event to the creditor. First, the creditor may realize a deductible bad debt loss on the foreclosure if part or all of the debt foreclosed upon is worthless. Second, if the creditor acquires the property at the foreclosure sale, he may recognize gain or loss on the foreclosure if the property foreclosed upon has a fair market value more or less than his basis in the amount of the debt for which the creditor purchased the property. This is because the creditor is treated as disposing of the debt in exchange for the fair market value of the property foreclosed upon. Later, if the property is disposed of in a taxable event, additional gain or loss may be recognized.

Since the Revenue Act of 1962 special treatment has been provided, however, for thrift institutions which acquire any property which is security for payment of a debt. If a thrift institution forecloses on the security for a debt owed to the institution (or otherwise reduces the property to ownership or possession by any process of law or by agreement), no gain or loss is recognized and no debt is considered as having become wholly or partially worthless regardless of the property's fair market value at the time of the foreclosure. Instead, the loan transaction is held open and the property received in the foreclosure (or other proceeding) is treated for tax purposes as having the same characteristics as the debt for which it was security.[2] The basis of the acquired property is equal to the institution's adjusted basis in the debt, increased by the costs of acquisition.

While, under this provision the acquisition of the security by foreclosure (or other legal means) is not itself a taxable event to a thrift institution, foreclosure may still have tax effects in the taxable year of foreclosure or later taxable years. For example, if the property foreclosed upon has depreciated in value below the thrift institution's basis in the property (generally the amount of the debt outstanding at the time of the foreclosure, adjusted for acquisition costs), the decline may be charged against the bad debt reserve of the institution (if that is proper under the institution's method of accounting), and the basis of the property reduced accordingly. If the property continues to decline in value, further loss deductions may be taken.

When the property is later disposed of, the amount realized is treated as a payment on the debt (closing the loan transaction). Thus, the disposition will generally generate either ordinary income (or a credit to the appropriate bad debt reserve account), or a bad debt loss at that time. Any income generated by the property and any deductions (other than depreciation) allocable to the property, retain their characteristics as rent, royalties, *etc.*

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[2] Thus, no depreciation deduction is allowable with respect to the acquired property.

This treatment is mandatory if the institution is a thrift institution in the taxable year of the foreclosure. For this purpose, a thrift institution is any mutual savings bank not having capital stock represented by shares, a stock savings bank which is regulated like a mutual savings bank, a savings and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

Issues

Under pre-1962 law, if a thrift institution acquired property at a foreclosure sale for an amount less than the unpaid debt, a loss deduction was allowable (if the excess was otherwise uncollectable). Further, a gain or loss could result on foreclosure if the property had a fair market value different from the creditor's basis in the amount of the loan bid at the foreclosure sale. In the case of the later sale or other disposition of the property, a third recognition event could occur. This provision eliminated these erratic results with respect to thrift institutions. It also discourages foreclosures to obtain depreciation deductions, which the law prior to 1962 may have encouraged. However, this provision provides thrift institutions with tax treatment different from that provided other taxpayers such as commercial banks. Some have suggested, therefore, that the treatment of thrift institutions acquiring property on foreclosure (or other legal means) be conformed with the treatment given other taxpayers (or vice versa).

5. Loss Carryback and Carryover Rules

Present Law

In general, for net operating losses arising in taxable years ending after 1975, taxpayers are permitted to carry a net operating loss back to the 3 taxable years preceding the loss year and forward to the 15 taxable years following the year of the loss. Commercial banks (and thrift institutions) are given different net operating loss treatment than taxpayers in general. Commercial banks, small business investment companies, housing development corporations, and certain thrift institutions are permitted to carry a net operating loss back to each of the 10 taxable years preceding the loss year and forward to each of the 5 taxable years following the year of the loss.

Legislative History

The extended loss carryback for banks, savings and loan associations and mutual savings banks was enacted in 1969, the same year that their bad debt reserves were reduced.

Issues

Generally, taxpayers will prefer a loss carryback to a carryforward because the carryback enables them to obtain an immediate refund while the carryforward only provides the possibility of a tax reduction in the future. Financial institutions argue that the volatility of their business, and the serious problems that arise for the national economy when they experience losses, justifies their receiving a longer carryback period than other businesses. They also argue that their ability to average income and losses over a 16-year period, rather than the 19-year period given to ordinary businesses, put them at a disadvantage and have suggested that they be given an 8-year carryforward.

Others argue that there is no valid reason why financial institutions should have different carryover and carryback rules than other businesses.

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